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YUMC - Q4 2017 Yum China Holdings Inc Earnings Call

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OVERVIEW:

Co. reported 2017 revenues of more than $7b, adjusted net income of $564m, and adjusted diluted EPS of $1.42. 4Q17 total revenues were $2.2b, net loss was $90m, and adjusted diluted EPS was $0.19.

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the Yum China 2017 Fourth Quarter and Fiscal Year Earnings Conference Call. (Operator Instructions) I must advise you that this conference is being recorded today, Thursday, the 8th of February 2018. I'd now like to have the conference over to your first speaker today, Ms. Michelle Shen. Thank you. Please go head.

Michelle Shen - *Yum China Holdings, Inc. - Director of Finance*

Thank you, Kevin. Good morning and good evening, everyone. Thank you for joining us. On our call today are Micky Pant, our CEO; Joey Wat, our President and COO; and Jacky Lo, our CFO. Please note a PowerPoint presentation and a live broadcast of this call are available through our IR website under the Events and Presentations section.

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 presentation also includes certain non-GAAP financial measures. You should carefully consider the comparable GAAP measures and the reconciliation thereto.

Now let's start with the agenda on Page 3. Micky will start with our Q4 and full year 2017 highlights, Joey will review brand performance and Jacky will discuss financial results. After opening remarks, we'll be happy to take questions from analysts and investors.

Now let me turn the call over to Mr. Micky Pant, CEO of Yum China.

Muktesh Pant - *Yum China Holdings, Inc. - CEO & Director*

Thank you, Michelle, and welcome, everybody. I assume you have access to our presentation online. And if you do, I will start with Slide #4.

So our fourth quarter results illustrate strong performance of Yum China, with total revenues reaching $2.2 billion, an increase of 9%, and overall same-store sales growth up plus 5%, both before foreign exchange translation.

KFC delivered an impressive performance with same-store sales up plus 7% for the quarter, and Pizza Hut also improved with same-store sales up plus 1% versus a year ago.

In Q4, we reported a net loss of $90 million due to a previously announced one-time tax charge, which came in at $164 million as a result of the U.S. tax reform. Excluding this impact, our Q4 adjusted net income was $74 million, an increase of 18% year-on-year, excluding ForEx. You'll get more details from Jacky Lo, our CFO, regarding the tax charge. Adjusted diluted EPS was $0.19, up 18% year-on-year, excluding ForEx.

In the quarter, we opened 339 new restaurants and reached a total of 7,983 restaurants. We are now in more than 1,200 cities across China. We continue to make strong progress in digital and delivery. Delivery sales reached over 15% of our company sales in the quarter, and mobile payment accounted for over half of our company sales. Our loyalty members for KFC surpassed 110 million, and Pizza Hut exceeded 35 million. We paid a dividend of $0.10 per share in Q4, and we've announced a dividend of $0.10 per share to be paid in Q1 2018.

Now let's take a look at the full year results for 2017, which is on Page 5. And with a strong Q4, I'm glad to report that we achieved solid performance in 2017, the first full year of Yum China operating as an independently listed company.

Full year revenues exceeded $7 billion, an increase of 8% year-on-year before foreign exchange translation, with overall same-store sales up plus 4% for the year. KFC same-store sales were up plus 5%, and Pizza Hut was up plus 1% for the year. Full year operating profit grew 23% to $785 million. Adjusted net income of $564 million represents an increase of 24% versus last year, excluding ForEx. Adjusted diluted EPS was $1.42, which is an increase of 15%, excluding special items and foreign exchange. Our adjusted EBITDA reached $1.25 billion, and cash and short-term investments were at $1.26 billion at the end of 2017.

We have exceeded our target by opening 691 new restaurants in 2017, including 101 new Little Sheep restaurants. We remodeled 788 stores led by KFC. And at the moment, over 75% of our stores are either new or have been remodeled in the past 5 years. Lastly, during the year, we repurchased 3.4 million shares totaling $128 million at an average price of $38.18 per share.

Moving to Slide 6, let's take a look at our annual sales performance, and later on Joey will walk us through the quarterly performance by brand. You can see we've steadily improved our top line performance with same-store sales up plus 4% after 3 years of decline and a flat 2016. This was driven by strong momentum at KFC and improvement at Pizza Hut. While the trend is encouraging, 2 years of strong performance in 2016 and 2017 have set up for a tougher lap for 2018. Our system sales grew 8% year-on-year, backed by a strong same-store sales and new store openings.

Let's move to Slide #7. Our restaurant margin continued to improve on the back of solid same-store sales and aided by the impact of retail tax structure reform, which is commonly known as VAT. Restaurant margin reached 16.8% in 2017, and operating profit increased 23% to $785 million, building up on the 31% growth in 2016. We maintained our ongoing targets of approximately 17% restaurant margin, and double-digit operating profit growth, excluding ForEx. As mentioned previously, 2 years of strong growth created a tough, challenging lap for 2018.

Let's move to Slide #8. And you've seen this slide before, but we continue to focus on 4 key strategic priorities for our business. The first is to continue to invest for growth in China, a market that we understand and where we have a record of leadership. The second is to continually strengthen our core business in KFC and Pizza Hut. The third is to strive to maintain our leadership position in digital and delivery through continued investment and stay at the forefront in these 2 areas. Our fourth priority is to drive future growth through innovation in products, store formats and day parts.

I'll come back at the end, but for the moment that concludes my opening remarks. And I'll hand you over to Joey Wat. Joey is our President and Chief Operating Officer. And as you know, from March 1, will take over as the CEO of Yum China. Joey, over to you.

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

Thank you, Micky. Greetings, everyone. Now let me summarize the performance of KFC and Pizza Hut in Q4 as well as full year of 2017, starting with KFC.

Slide 10 highlights the key performance of KFC in 2017. KFC delivered solid top line performance with same-store sales up 5% and system sales up 9% year-on-year. We've built 408 new stores and remodeled 644 units. Our financial performance was also strong. Restaurant margin and operating profit continued to improve. Jacky will cover the numbers in more detail.

On Slide 11, you will see that same-store sales grew 7% in Q4, making our fifth consecutive quarter of growth. It was up 5% for the full year and second year of positive growth, driven by 2% growth in transaction and 3% growth in ticket average. We are very pleased with our Tier 1 cities performance, with Beijing and Shanghai leading the growth. While we are very encouraged by the recent solid momentum in KFC, we want to caution you that we will be facing tough challenges in 2018, lapping 2 years of very solid sales growth, especially in Chinese New Year.

Now let's move on to system sales on Slide 12. We maintained double-digit system sales growth in Q4, resulting in a full year growth of 9%, driven by strong same-store sales and new store openings.

Let's move to Slide 13. One of our biggest factors that contribute to the solid performance at KFC was our continuous focus on food. In Q4, KFC launched a series of innovative products, including: Musang King Durian pizza (sic) [eggtart] (foreign language). The new eggtart was well received by consumers and created good social buzz. KFC also launched other new products such as jumbo chicken legs and chicken coated with Lay's chips. Right now, we -- our star product is Nuo Mi Ji (Chicken wing with sticky rice). It's in our stores, if you're coming through China, it will be sold out soon. It's very, very good. Second, KFC's focus on creating abundant value to our customers during the festive seasons, such as different sizes of buckets to fit customer needs. Third, Chinese consumers are continually upgrading their choices and, hence, their increasing need for more premium ingredients. We launched shrimp and scallop congee, (foreign language), in Q4. Together with the new flavor for our milk, we further strengthened our breakfast day parts.

Slide 14. Going digital is an essential step to engage with our customers. We offered our members exclusive privileges such as value and trial of new products. Examples in Q4 include buy 1, get 1 free for selected products, and the exclusive trial of the crayfish burger before its official launch (foreign language). We started offering our members merchandise in our K-Mall and T-Mall. Members can use their combination of member points and cash to redeem the product. KFC loyalty numbers exceed 110 million, a considerable size even in China. Member sales represent a significant portion of our sales already, reaching 38%. Mobile payment also continued its fast pace of development and reached 57%. We will continue to build our capacity and capability to maintain our leadership in the digital front.

Slide 15. Delivery continued its growth. In 2017, delivery represented 11% of KFC company sales, up 47% year-on-year. Right now, over 3,200 stores across 900 cities offer delivery services. We continued attractive offer in delivery to complement our dine-in business, such as discounted buckets, free gift and free delivery for orders reaching a certain order size. In November 2017, we launched KFC Delivery Prime, which offers our members unlimited free delivery for 30 days at the subscription fee of CNY 18. This program is limited to orders placed through our brand app or website only. Thus, it helped drive traffic to our own channels. We believe our digital and delivery capabilities provide a strong foundation for future growth.

Now let's move to Slide 16. Let's review the performance of Pizza Hut. In 2017, same-store sales grew 1% from last year, while our system sales increased 7%. We've built 180 new restaurants and remodeled 144 stores, a step change from last year as we started a more flexible remodeling program in 2017 for Pizza Hut. Pizza Hut reported operating profit growth of 8% from last year. Jacky will cover the numbers in more detail.

Let's take a look at the same-store sales growth on Slide 17. Pizza Hut same-store sales grew 1% in Q4 with 5% traffic increase, partially offset by 4% down in ticket average, mainly driven by increases in the delivery business and value offerings. We also ended the year with 1% same-store sales growth, the first year of positive growth since 2013. While the growth is encouraging, there's still a lot of work ahead of us.

Turning to Slide 18. Our system sales growth stabilized at 6% year-on-year in Q4. Full year was up 7%, an improvement over last year.

Move to Slide 19. In October 2007 (sic) [2017], we launched our new menu featuring 15 new products. In 2017, there were 22 new and 28 upgraded products launched across all categories. We have invested and we will continue to invest in our food. In addition to the national campaign, we have been conducting pilot tests for new ideas. One good example is the Italian-thin pizza pilot tested in Beijing and Shanghai in keeping with the changing taste. Successful pilots will be rolled out subsequently. We have engaged leading celebrities, such as William Chan Wai-ting, as our brand ambassador, who will leverage their popularity to introduce fun and interesting new products, such as Black Pizza, to the younger generation.

Turning to Slide 20, a quick review on our digital efforts. Pizza Hut achieved over 35 million members by the end of 2017. We strengthened our member campaigns and increased member sales to 34%. By the end of November, we rolled out Super-App version 2 with better look. Let's not forget we rolled out the version 1 only during the summer last year. A more user-friendly interface with a faster speed is available in the version 2. Other new functions will be introduced in 2018 to enhance customer experience. Pizza Hut mobile payments account for 45% of Pizza Hut company sales in Q4, similar to the rising trend of KFC.

Slide 21. As discussed last quarter, we have integrated our dine-in and delivery network under 1 logo and 1 brand. Delivery represents 20% of Pizza Hut sales in 2017, up 41% year-on-year. Over 2,100 stores now offer delivery services. We have good progress in integrating the delivery system to support growth, although not easy. For example, over 60% of menu has been integrated between dine-in and home service. We are also consolidating the store network and have identified certain stores for closure. The rationalization of our store network will help our future growth.

In 2017, now we are on Slide 22, Pizza Hut refined its multiple model strategy, addressing the need of different customers and occasions. In addition to our core model, we opened Pizza Hut Bistro, a smaller size fast casual concept. This service model is intended to reduce waiting time and improve efficiency. We are also testing other store formats to support further store expansion. In 2017, we launched a new remodeling program, which significantly lowered capital investments and sales loss. It's very important to keep our assets refreshed and relevant to our customers.

Let's turn to Slide 23. We continue to revitalize Pizza Hut in 2018 focusing on 4 key areas: first is to fix the fundamentals from menu to store ambience; second is to enhance digital capabilities through expanding our user base and engaging them; third, to optimize delivery using our brand app while working closely with aggregators; last but not least, experiment new models to drive further growth.

Slide 24. We opened 2 new Taco Bell restaurants in Shanghai. One is in a premium shopping mall in Wu Jiao Chang. The store serves thousands of students close by. The other one, in the Feng Sheng Li, which is a popular shopping and tourist spot in the heart of Shanghai. The 2 new restaurants feature a new dinner menu exclusive to China and a new service model, of which orders are delivered to the tables. We are excited to welcome more customers to experience Taco Bell and look forward to growing this vibrant brand and global brand.

That concludes my remarks. Let me turn it over to Jacky Lo, our CFO of Yum China. Jacky?

Jacky Lo - *Yum China Holdings, Inc. - CFO and Treasurer*

Yes, thank you, Joey. Good morning to those calling from Asia, and good evening to those calling from the U.S. So let me start with an overview of our fourth quarter and full year results and then give you some color on our 2018 outlook.

Let's take a look at our Q4 and full year 2017 results on Slide 26. Our system sales grew 9% in Q4 and 8% for the full year, excluding the impact of foreign exchange. This was led by our strong same-store sales growth and robust development plan. Full year restaurant margin reached 16.8%, up 1.5 percentage points year-on-year. I'll elaborate on the drivers for restaurant margin expansion in the subsequent slides. On the back of strong revenue growth and margin expansion, I'm pleased to report that we delivered adjusted net income growth of 18% in the quarter and 24% for the full year, excluding foreign exchange impact. As Micky mentioned at the beginning of the call, our reported net income include a one-time tax charge of $164 million as a result of the U.S. tax reform. And I'll explain more about this impact in subsequent slides.

Moving on to Slide 27, let's take a look at KFC first. KFC had a strong fourth quarter. Restaurant margin increased 2 percentage points in Q4 and reached 18.1% for the full year. Full year margin improvement was primarily driven by same-store sales leverage and aided by VAT benefit in the first half of the year and was partially offset by wage inflation and promotion cost. In Q4, KFC also benefited from a moderate commodity deflation. For the full year, operating profit increased 29% year-on-year.

Turning to Slide 28, let's look at Pizza Hut. During the fourth quarter, Pizza Hut's restaurant margin declined by 4.2 percentage points year-on-year, mainly due to product upgrades, promotion cost as well as wage inflation, and was partially offset by labor efficiency and same-store sales leverage. For the full year, Pizza Hut's restaurant margin improved 50 basis points year-on-year. In addition to the factors just mentioned, VAT contributed to margin expansion in the first half of the year. As we discussed on the Q3 earnings call, food investment is part of the brand's revitalization strategy to fix the fundamentals and is vital in driving businesses. In Q4, we invested about $20 million in product upgrades, and we also had a store network integration impairment charge of $6 million. So as a result, the operating loss was $20 million in Q4. Overall, 2017 operating profit was $157 million, an encouraging growth of 8%, excluding the impact of foreign exchange. I would like to remind you that product investment will continue into 2018. And as a result, we expect there will continue to be impact on our margin and operating profit.

Now let's move on to Slide 29 and talk about our development effort. We accelerated our new restaurant openings to 691 stores, reaching almost 8,000 stores across the country, and we maintained a steady pace of new builds across city tiers. KFC has a relatively deeper penetration in lower-tier cities, while 57% of the KFC stores are in Tier 3 or below. On the other hand, Pizza Hut is more concentrated in higher-tier cities, of which 60% of the stores are in Tier 1 or 2 cities. And in terms of new unit return, the average pretax cash payback for KFC is similar across city tiers at around 2 years, while Pizza Hut enjoys a slightly faster payback in higher-tier cities. We believe China continues to offer great opportunities for unit development, and we'll continue to capture these opportunities with discipline and focus.

Let's go to Slide 30. There were several factors that impacted our 2017 financial results. As mentioned earlier, same-store sales leverage, VAT benefit and productivity increase are the key drivers to our profit growth, and VAT was no longer a tailwind from Q3 onwards. Wage and commodity inflation have always been a pressure faced by our business. In 2017, wage inflation was 7%, and commodity inflation was slightly above 1%. Since we are in our first year as a public company, we incur additional G&A cost to meet the governance reporting and compliance requirements. G&A cost was up 16% year-on-year in local currency. But this sets the new base of our public company G&A cost beyond 2017, and we'll continue to look for ways to optimize our G&A cost structure in 2018. Overall, our adjusted operating profit increased 23% year-on-year in 2017, excluding foreign exchange impact.

Let's turn to Slide 31. As a result of the Tax Cuts and Jobs Act, the company incurred an estimated one-time tax charge of $164 million or $0.42 per diluted share. Of this $164 million, the net cash payment is estimated to be $83 million to be paid over 8 years, and you can see the details on the slide. These are the best estimates based on currently available information. And with further clarification on the U.S. tax reform, our current estimates may be subject to change. With operations primarily in China, we continue to be subject to China enterprise income tax of 25% and an additional 10% withholding tax on any earnings repatriated outside of China, levied by the China tax authority. The reported effective tax rate of 2017 was 47% or 26.9%, excluding special items.

Slide 32 highlights the powerful aspect of Yum China's business model, which is our ability to generate a substantial amount of cash. We generated free cash flow of $469 million and ended the year with $1.26 billion in cash and short-term investment. In 2017, we repurchased 3.4 million shares totaling $128 million, and initiated a regular quarterly dividend at $0.10 per share. Given our strong cash flow generation capability, we'll continue to utilize cash to reinvest into our core business, enhance our strategic position and create value for shareholders.

Now let's turn to Slide 33. We'll make 3 key reporting changes in 2018. The first reporting change relates to the adoption of the new revenue recognition accounting standard, which has no significant impact to our income statements. You can refer to the details on the slide. The second and third reporting changes aim to provide better transparency and align with industry standard.

First, we'll follow a calendar quarter-end and classify our quarters into 4 3-month quarters, and we'll also fine-tune our same-store sales growth calculation by using a stable base of stores for the whole year as opposed to a rolling base of stores which changes month-to-month. There's no significant change to our historical same-store sales growth numbers. We'll provide recast 2016 and 2017 financial data through an SEC submission in April 2018 for better year-on-year comparisons.

Let's move to Slide 34. I want to provide you with the outlook for 2018. We have captured here for you the opportunities and risks. On the plus side, we expect the economy to grow steadily. Robust demand in delivery and growing membership program will help to drive our businesses. Sales momentum at KFC will also contribute to our growth in 2018. However, we do see some challenges. As you have heard from Micky and Joey, 2 successful Chinese New Year in 2016 and 2017 will make the lapping in 2018 tough. While we are on track with Pizza Hut revitalization, we may still face roadblocks. We also expect to see commodity inflation of low single-digit and labor inflation of high single-digit. Lastly, we continue to face uncertainty in tax laws.

On the development front, we are confident we'll be able to deliver 550 to 600 new units for the full year, and digital and delivery will continue to be our growth engines. We maintain our ongoing financial targets of high single-digit system sales growth, around 17% restaurant margin and double-digit operating profit growth, excluding foreign exchange impact, although there will be fluctuations quarter-on-quarter and year-on-year.

With that, I hand over to Micky for the summary.

Muktesh Pant - *Yum China Holdings, Inc. - CEO & Director*

Thank you, Jacky, and thank you, Joey. We will open up for Q&A in just a minute. But on Slide 35, we have a very short summary.

First is we are very pleased overall with the strong performance of KFC and with the pace of Pizza Hut's revitalization in 2017. Our new store builds exceeded our targets. We also delivered strong sales and profit growth and maintained a healthy cash position. As been mentioned a couple of times already, we've had 2 consecutive years, especially 2 conservative Chinese New Years that have been very strong, so 2018, we'll have to lap that. As Chinese New Year is a critical period, we'll focus all our efforts to make that successful in coming weeks. In 2018, we'll also continue to focus on 3 key priorities. First is to maintain KFC sales momentum, continue the revitalization of Pizza Hut and drive our digital strategy.

So that's a quick summary. And with that, I'll return you to Michelle so that we can commence our Q&A.

Michelle Shen - *Yum China Holdings, Inc. - Director of Finance*

Thanks, Micky. (Operator Instructions)

Operator, please provide instructions for Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And we have our first question here from John Glass from Morgan Stanley.

John Stephenson Glass - *Morgan Stanley, Research Division - MD*

First, Micky or Joey, just on your comments about a more cautionary stance in the first half. When I look at it, you've had 4 years prior to the last 2 of negative same-store sales. While laps are tough, you're coming off a low base versus prior years. So if you could just put that in context about the prior 4 years, now your 2 successful years, and why that's tougher. And is your comments really around -- specifically around the Chinese New Year holiday and the volume you should experience then? Or was your comment more broadly about the first half as more difficult? And then I have a follow-up after that, please.

Muktesh Pant - *Yum China Holdings, Inc. - CEO & Director*

Thank you, John. I'll start quick and then hand over to Joey. You said it exactly right. It's an opportunity and a threat. The opportunity side, as we pointed out, there seems to be a good sales momentum. We were negative. We turned flat in '16. In '17, we grew plus 4%, so that's one indicator. However, it cannot be avoided that plus 4% was lapping a flat sales performance in 2016. And normally, in our business, you know very well that sequentially building same-store sales growth is more difficult than we are lapping a relatively easy year. So we have to balance these factors out. As far as the timing, et cetera, is concerned, look, I think we -- first, you should take from us that we are very optimistic about the business longer term. But Chinese New Year in this year is later than last year, it's yet to start. So we have no idea how it will go -- or not -- we don't have no idea, we have plans, very detailed plans, but all of it will depend on the performance of the next month. So it's impossible to say right now what Q1 will look like, albeit cautioning that the last 2 years have been really, really strong. So we have to be open to the possibility of meeting it or missing it. We'll have to see how it goes. Joey?

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

Thank you, Micky. John, I think I'll probably refer back to the Page 11. If we see the quarter number, 2017, we were very nervous about whether we can lap the Chinese New Year because 2016, you look at the first quarter, it was at +12%, it's double-digit. And Chinese New Year is one of the top 2 peak trading seasons for us. So we -- in our business in China, we have 2 peak trading periods, the Chinese New Year and summer. So 2016 was so strong, it exceeded our expectations in terms of sales and profits. So we are very pleased that we can lap in 2017, so 2018 is another challenge. And not to mention, because it's a relatively short period of time, it's like 3 to 4 weeks' time, and the sales intensity has gone up so much, there's a certain capacity in our store, in how many people can we serve. Not to mention on the labor side, it's harder and harder to make sure we have enough labor to trade every day on Chinese New Year. I mean, we literally trade through every day even on the first day of Chinese New Year, which typically is the day that everything shuts down, but we don't. So therefore, we are cautious about the 2018 Chinese New Year. We'll definitely try our best, but anything like from big snow or something happens, it would impact our sales because it's very concentrated, very high-intensity sales during a very short period of time and, hence, the caution, John.

John Stephenson Glass - *Morgan Stanley, Research Division - MD*

That's helpful. And just on the Pizza Hut margins, was there anything in the fourth quarter that was one time in nature? I think there was an impairment or some sort of charge. But in the food or labor that was one time due to the new menu rollout, I'm trying to assess, I guess, is this what the new -- I know there's seasonality in your margins, but is this the new run rate that you're going to be, I don't know, 400 basis points below on a full year '18 versus '17 now that the new menu's in place and new labor standards? Is there any way you can help frame the new margin impact for this new menu into '18?

Jacky Lo - *Yum China Holdings, Inc. - CFO and Treasurer*

Sure, John. This is Jacky. So as part of the Pizza Hut revitalization plan, so as you point out, we make investment in product upgrades, and also we have promotion cost for CRM and delivery. So all in all, as I mentioned in my prepared remarks, the impact was about USD 20 million. So that's about 4% -- or 3.5% on our margin. So -- and we have full intention to make similar investment in Q1 and Q2 2018, so there will continue to be a similar pressure on margin and operating profit.

Muktesh Pant - *Yum China Holdings, Inc. - CEO & Director*

Onetime?

Jacky Lo - *Yum China Holdings, Inc. - CFO and Treasurer*

Now in terms of onetime, yes, as you point out, it's the network integration impairment charge of $6 million. That's one time. But we're still assessing, the integration is still ongoing. So yes, there may be potentially some additional impairment charge in 2018.

Muktesh Pant - *Yum China Holdings, Inc. - CEO & Director*

Yes. I think, John, when you -- we'll have to watch the next couple of quarters because, as we said, Pizza Hut is a work-in-progress. We're not declaring that the turnaround has happened. The turnaround has started. We are very encouraged by the experimentation of new formats. I think Joey has done the right thing by upgrading products that has taken a toll on our margins. These are all steps in the right direction to improve the value offering. So let's watch the next couple of quarters and then maybe we can give you more assessed guidance of where we think. The good thing at least is the sales are looking reasonable and the traffic is helping, so...

Operator

The next question comes from Christine Peng from UBS.

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

My question is really about the food inflation. As you may have noticed food inflation is actually coming back to China. And I was just wondering what is management's view towards the pricing strategies for KFC and Pizza Hut, respectively, in 2018? Will there be any plans to hike the prices for these 2 brands, especially for KFC, given the very strong growth momentum for the brand since the Q3 of last year?

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

Christine, thank you. We will be prudent about pricing for both brands. As we mentioned in the presentation, we've got smart value and abundant value. So where we have newer and innovative products, we charge higher. We also charge higher at higher-traffic stores. Like you might or might not notice, if you buy KFC at (foreign language), the high-speed railway station, you will be paying slightly a higher price. But we maintain competitive pricing with our customer to protect the value for money for our customer. And on top of that, we also use a mix of products and mix of tiers, we have different price tiers to protect the ticket average as well. So we'll continue that.

Operator

Our next question comes from Matt McGinley with Evercore.

Matthew Robert McGinley - *Evercore ISI, Research Division - Restaurant Analyst*

I have a question on the context of lapping the compares. At KFC, you seemed to have nailed it to flex the labor hours with the growth in the comps throughout last year fairly well despite the wage inflation. I understand Joey's comments she made before on how in new years, it becomes difficult to flex the labor model with that. But on the difficult compares you have throughout the entire first half, are you implying that there's something different with the labor model that makes it harder to maintain the margins through the first part of the year on those more difficult compares?

Muktesh Pant - *Yum China Holdings, Inc. - CEO & Director*

Not differentially in 2018 compared to '17. There's no fundamental change in the model or anything. I think Joey's point was that Chinese New Year is so critical that selling volumes are somewhat dramatically higher. But you really have to perform everything to perfection. There's no particular change in the business model. Obviously, labor is getting more difficult every time -- everyone wants to go home at Chinese New Year's, so we got that difficulty.

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

Matt, as I try to understand your question, what I really mean is Chinese New Year is the availability of labor. Because by law, for the few days of Chinese New Year, we pay 3x of the normal salary. In order to have staff serving during those few days, we typically start the planning 4 to 6 months in advance. It's never easy. It will never be easy. But we'll continue to work on that. But just want to point out that it's a very tough trading period that we have to be very, very detailed and careful, particularly on the labor availability side. I hope that answers your question.

Matthew Robert McGinley - *Evercore ISI, Research Division - Restaurant Analyst*

Yes, that does it. It's more of a first quarter comment than a full year comment. That's helpful. And on the G&A, it's -- I'm having a hard time understanding what the base is that we should build 2018 off of. You had such a large increase in the back half of the year, with the explanation being it's the cost of running a public company. But it's well over the rate of sales, and the back-half growth was significantly larger than front-half growth. So can you help us understand what it look like either on a dollar basis or with the growth we should expect to see in 2018 relative to the kind of lumpy nature of that G&A in 2017?

Jacky Lo - *Yum China Holdings, Inc. - CFO and Treasurer*

Yes. Matt, thank you for your question. So as you understand, we are in our first full year as a public company, so we are incurring some additional costs to meet the different requirements like governance reporting and compliance. So I mean there's a lot of learning experience well in our first full year as a public company. So -- but right now, we believe we have set the base G&A cost for a public company. And so we will actively manage the G&A cost and identify cost savings opportunities. So right now, we are actually working across functions to analyze and optimize our structure. But in the longer term, our goal is to keep G&A increase below our revenue growth.

Operator

And our next question comes from Xiaopo Wei from Citigroup.

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

The first question is for Joey regarding Pizza Hut revitalization program. We noted that you said that you are continuing investment in the product. Will we see that -- after you've seen continued recovery of Pizza Hut and same-store sales, will you reduce such investment in the second half of 2018? That is the number one question. The number two question is about store expansion. We noticed that the company has been opening a lot of new unit and also remodel a lot of stores. Will we expect a slowdown in the close the stores in 2018, meaning the net increase of store will be higher in 2018 versus 2017?

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

Thank you, Xiaopo. For the food investment, we will continue the food investment because there are many things that we can compromise but, from a customer point of view, food quality and value for money is not an area that we should compromise. Not only we should improve our food, we should improve our food to a great extent to bring the customer back while maintaining the investment because I think, as Micky mentioned before, in the past, I think our cost of sales in food ingredient is a bit low. So we are just really bringing it to the normal and reasonable level. For the second half, I think in terms of -- so we actually reduce the investment or increase price per se, I think we'll pursue a more diverse strategy to look at the mix of our product because, typically, as you might be aware already, the cost of sales in food is slightly higher than drinks. So that's something we probably can do in drinks to balance, so the mix of food, the mix of the pricing tier across the country, et cetera. So that's the area we can work on. For the new unit, I remain cautious because the new unit, how many we open, it has certain relationship with how well the business is recovering. And in terms of closure, as Jacky mentioned earlier, particularly we had -- we are quite -- we are, I will say, 60%, 70% there with the integration of Pizza Hut Home Service business, but the process continues. So we are still in the process of consolidating the store network and assessing what store to close or not. So that is the ongoing process, and I won't be able to give very clear guidance, it would be more or less. I think our #1 criteria is do the right thing, make sure the stores we keep are healthy. And if we have to close certain store because it's the right thing to do, we'll do it. I hope that answers your question, Xiaopo.

Muktesh Pant - *Yum China Holdings, Inc. - CEO & Director*

Yes. I think -- Xiaopo, this is Micky, just one more. I think this came up before. We opened 691 units, and about 100 of those were Little Sheep restaurants, and they were all opened by franchisees other than our own capital. So just keep that in mind. And Little Sheep we have a fantastic year, in the year, we're very pleased we're grown in many countries and doing well. But that's a different business altogether.

Operator

And the next question comes from Sara Senatore from Bernstein.

Sara Harkavy Senatore - *Sanford C. Bernstein & Co., LLC., Research Division - Senior Research Analyst*

Just actually 2 follow-ups, if I may, on topics that have already been addressed. The first is about the Pizza Hut margins. I just want to make sure -- I missed -- I didn't miss something. I know there are some investments, but are you seeing margin impact from a mix shift towards delivery aside from just there being lower average check? Are there -- are delivery orders just lower margin in general? And to the point about beverages, is that a part of it? So that was my first question. And then my second question is actually about the store base rationalization. Is it that you're seeing cannibalization in some dense markets? Is it that some of the newer markets with the lower returns maybe not working quite as well as expected? Can you give a sense of where that's happening?

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

Thank you, Sara. For the Pizza Hut margin, the delivery business, we maintained very healthy margin and pricing for the delivery business, and we charge customers the delivery fee as well. From here and there, we might run some additional promotion on the delivery depending on occasion. But we don't see a big cannibalization of the margin from the delivery side, so we are comfortable to grow our delivery business as aggressive as we could. For your second question, store base rationalization, because historically, Pizza Hut Dining and Home Service, they were run as separate business so, therefore, it was quite normal that in a good trade zone, probably both business are there. Now when we put it under 1 brand, we looked at it, we do our numbers, and we ask ourselves, in certain trade zones, do we really need 2 stores or 1 store? Sometimes we need to maintain 2 stores if that's enough volume. And in some other case, we might have to take out one, which will help the other one but also there's not enough capacity yet for now. So because of the integration -- so therefore, there's an equal rationalization instead of some regional difference, et cetera, per se. So I hope that answers....

Operator

And the next question comes from Brian Bittner from Oppenheimer.

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

I got 2 questions. First, I'm just still slightly confused on the caution regarding the laps in the first part of the year. Is there something very specific in the Chinese New Year this year that makes it just clearly more difficult for you to execute? Or are you kind of flagging or seeing a more skittish consumer as you head into this year's new year? That's my first question. Second question is, just with all the investments you're making in 2018, what overall comp or same-store sales growth do you need to see to hold margins flat in 2018?

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

I think I will take the first question, and then Jacky can take the second question. For the Chinese New Year, it is a bit like being a retailer during Christmas. Every year is a difficult and nervous year because the sales is so high so -- and then, in our case, as I mentioned earlier when John asked the question, 2016, the number was so, so high both in terms of sales and profit that we are caution about it. And if I'm pushed to say what is the biggest difference, I think 2016 was very unusual because that's the year of monkey, and we somehow, in our Chinese traditional kids culture, as you will see, the Monkey King is just such a popular iconic icon for Chinese of all ages that we managed leverage. And then, of course, last year was the year of chicken, and we sell chicken. So that's something that we -- in terms of marketing-wise, we can engage our customer very well. Now 2018 is not an easy task. Although, as Micky mentioned, we have a very solid plan. But it's the year of dog. It's very difficult to have a very positive spin of the word dog, but that's -- it's more like internal, sort of a casual view -- not casual, like sort of we tease ourselves for the challenge for 2018. But with that said, the campaign every year, we just have to come up with something very new, very innovative, to make sure we continue to engage our customer within such a short period of time. It's just very -- it's a nervous period of time, let me put it that way. For the second question, Jacky?

Jacky Lo - *Yum China Holdings, Inc. - CFO and Treasurer*

Okay. Well, Brian, well, first of all, we are very committed to achieving the ongoing financial target of 17% restaurant margin, but that's our long-term goal. So like I said, there will be fluctuations quarter-on-quarter or year-on-year. But as you can appreciate, about 90% of our restaurants are actually equity-owned. So the first priority and the most important priority is to maintain healthy same-store sales growth and also focus on driving traffic growth. So we have some very exciting marketing campaigns and innovative products coming out for Chinese New Year and for the rest of the year. So as you can appreciate, this will bring huge flow-through impact to our margin. But we are also facing commodity inflation of low single-digit and labor inflation of high single-digit. So we will also focus on improving our in-store efficiency as well just to offset these inflations. But our overall (technical difficulty) we believe is the right thing to keep investing in our COS product upgrade. And so the impact will be similar to -- or the magnitude will be similar to Q4 in 2017. So obviously, that will create some pressure on our margin, but our focus right now is just to continue to drive our same-store sales growth.

Operator

And the next question comes from Michelle Cheng from Goldman Sachs.

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

I have 2 questions here. Number one is regarding the member contribution. We see very encouraging contribution for both KFC and Pizza Hut. And can you give us some comparison base in 2016 member contribution and also the ticket size difference between the members and also the average customer? That's my first question. And secondly, I still want to clarify a little bit on the new unit Joey just mentioned. I understand that we will be more cautious on the Pizza Hut, it's still in the integration process. But how about KFC? Given we have seen pretty strong same-store sales growth and also the margin expansion, is that likely we can accelerate the KFC expansion in the next few years?

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

Okay. Thank you, Michelle. For the member contribution, I think for the details, our IR team can get back to you. But we certainly can say that we have grown our members fairly significantly in terms of both absolute numbers, because we are right now over 110 million for KFC and 35 million for Pizza Hut, and then the member sales is very, very significant compared to 2016. And then both -- for both business, we are quite delighted to see slightly better traffic frequency and ticket average for our customers. So that's a good thing. And we certainly will continue to engage and invest in our membership program. Second question is on KFC store acceleration. I think it's a very good question. We certainly keep revising our pipeline. And then as I mentioned earlier, the new store opening, it has certain relationship with the improvement of same-store sales because the better the sales, the more pipeline that's available and the more locations that we can afford the rent. So we will continue to modify and revise our store pipeline. And if we see the right site that we can open more stores, we'll certainly go for it. Why not?

Operator

And the final question today comes from Chen Luo from Bank of America Merrill Lynch.

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

I've got 2 questions. The first question here is on the occupancy cost. So that cost as a percentage of sales has declined quite dramatically. Apart from the smaller unit size and the same-store sales growth leverage, is there any other reason behind the decline? Do we expect a continued decline or meaningful decline in that ratio heading to 2018, which can help us to offset the pressure from food inflation and wage inflation? And the second question is on the delivery business. So that business is doing fantastically these days. And can you give us an update on the percentage of delivery orders which are coming from the online aggregators? And also the economics behind that, how much would they charge us for these kind of deliveries? And are we concerned that, in the future, they are going to raise the fees that they charge us?

Jacky Lo - *Yum China Holdings, Inc. - CFO and Treasurer*

Chen, I'll take the first question first. On our occupancy improvement, that mainly came from sales leverage. But also for Pizza Hut, we shift the advertising and media cost to product upgrades. So -- and also in the first half, there were some VAT benefit as well. So that's why you see occupancy improvement year-on-year.

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

And also, I'd say, if I add, for the occupancy cost, very significant of our stores, the rent is based on percentage of sales so -- which protect our business model. And of course, as you can imagine, negotiation with our landlord is our core strength, so we'll continue to work very hard on that one. When it comes to delivery, the percentage of orders from aggregators. I believe I mentioned it before, not in today's call, in Investor Day, for KFC business, about roughly half of our traffic is from aggregators. But let's not forget, we do all the delivery, the physical delivery of food ourselves, and we have captured all the traffic data in our system. And then the traffic of delivery business for Pizza Hut, the percentage is slightly higher from the aggregators. So our own channel ability to drive traffic is that area that we are working very hard on. Now in terms of the commercial arrangement with the aggregators, unfortunately, we will not be able to provide you with such information because we are bound by confidentiality agreement with the aggregators.

Muktesh Pant - *Yum China Holdings, Inc. - CEO & Director*

Okay. Well, thank you very much for your questions. Back to Micky. And I just want to express my personal gratitude. It's been a joy and a great privilege to lead Yum China over the last couple of years. And just generally, I'm very confident and very pleased to hand over the reins to Joey Wat as our new CEO. As you know, she had demonstrated track record. She's been excellent. She's the right person to lead this company as we head into 2018. So thank you very much.

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

Thank you, thank you, Micky. All of us at Yum China, we are committed to building leading brands for the long-term through innovation in all aspects of our business. We will focus on our strategic priorities on digital and delivery while continuing to improve our food and in-store experience. While we finish 2017 with solid sales momentum, we continue to face challenges of the revitalization of Pizza Hut and lapping of 2 very successful Chinese New Years. However, I remain confident in the growth opportunities and long-term prospects of Yum China.

Michelle Shen - *Yum China Holdings, Inc. - Director of Finance*

Thank you, Joey, and thank you, Micky. With that, we conclude today's call. Thank you.

Operator

Thank you. Ladies and gentlemen, that does conclude our conference call for today. Thank you to all participating. You may all disconnect, and goodbye.