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# EDITED TRANSCRIPT

YUMC - Q1 2018 Yum China Holdings Inc Earnings Call

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**OVERVIEW:**

Co. reported 1Q18 total revenues of \$2.2b, net income of \$288m, and diluted EPS of \$0.72.



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**Millicent Tu**

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## PRESENTATION

### Operator

Ladies and gentlemen, thank you for standing by, and welcome to the Yum China 2018 First Quarter Earnings Conference Call. (Operator Instructions)

I must advise you that this conference is being recorded today, 2nd of May 2018. I would now like to hand the conference over to your first speaker today, Ms. Millicent Tu. Thank you. Please go ahead.

### Millicent Tu

Thank you, operator. Hello, everyone, and thank you for joining Yum China's First Quarter 2018 Earnings Conference Call. Please note that a PowerPoint presentation and a live webcast of this call are available on our IR website under the Events and Presentations section. Joining us on today's call are Ms. Joey Wat, CEO of Yum China; and Mr. Jacky Lo, CFO of the company.

Before we get started, I would like to remind you that our earnings call and investor presentation contains 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 reconciliation thereto.

Today's call includes 3 sections: first, Joey would discuss Yum China's first quarter 2018 highlights and Jacky will discuss the financial results. We will then open the call to questions. At this time, I would like to turn over the call to Ms. Joey Wat, CEO of Yum China. Joey?

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

Thank you, Millicent. Hello, everyone, and thank you for joining us today. This is my first earnings call since I became the CEO of Yum China. I'm very excited with opportunities ahead, and I would do my very best to build a stronger Yum China with the wonderful Yum China team. I would like to begin with Slide 4, providing a few high-level comments on the quarter.

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Yum China achieved growth in both revenue and profits, accelerating the rate of new builds during the past quarter. We value return to shareholders and declared a cash dividend of \$0.10 per share. With a strong cash flow, we reinvented -- sorry, we reinvested in our business, acquiring an additional 36% equity interest in Wuxi KFC, increasing our total equity interest to 83%. KFC continued to shine and excel both financially and operationally, successfully lapping 2 strong first quarters in 2016 and 2017. Pizza Hut, however, experienced a bumpy quarter. We made some bold trials on food, and some lessons were learned. We are committed to revitalizing Pizza Hut, but the effect will take time to show. I'll give more color later on in the call. Delivery continued to fuel the growth, and loyalty membership increased at high double-digit year-over-year for both brands.

Next, let's move to Slide 5, discussing the overall performance of KFC. KFC delivered solid top line performance in the first quarter of 2018, with same-store sales up 5% and system sales up 9% year-over-year. We built 144 new stores compared to 85 for the same period last year. A total of 118 units were remodeled, an increase of [34] (corrected by company after the call) compared to the same period last year. Restaurant margin improved slightly to 20.9% compared to the same quarter of the prior year. Operating profit grew 11% year-over-year, excluding foreign exchange. Jacky will provide more color later on.

Looking at Slide 6. One of the key factors contributing to KFC's excellent performance is our ability to innovate, delighting consumers with a series of new products. KFC launched Crayfish Burger, stuffed chicken wing and spicy chicken burger, all of which were very popular among our consumers. Crayfish is a premium ingredient popular among Chinese. Stuffed chicken wings, (foreign language) is a delicacy in Guangdong, requiring a lot of labor, and usually served at high-end Chinese restaurants. We made a breakthrough by offering premium products at very affordable prices.

Besides food innovation, KFC offered abundant value for our signature products to capture different consumer needs during the Chinese New Year, from a single-person combo, small bucket to jumbo Chinese New Year bucket. The combination of premium new products and abundant value successfully drove our ticket average in Q1.

Slide 7 is a brief recap of our marketing efforts, which was effective to drive sales. The Chinese New Year is an important period and to capture such a vital sales window, on a national level, we deployed a multilayered and content-rich marketing campaign covering off-line and online, using multiple celebrities and IP to target a variety of audiences, from kids to young adults to mature consumers. We are extremely proud that we had the opportunity to work with China's National Museum to decorate some of our stores with the Chinese traditional themes and characteristics during the Chinese New Year. This type of event generates a lot of positive media coverage and customer reviews. In addition to the national campaign, each region also designed and launched their localized campaign tailored for their markets. Our efforts paid off as we drove strong sales growth in the first quarter.

I would like to touch on our digital and delivery progress on Slide 8. We continue to maintain our leadership in digital and delivery in the restaurant sector. KFC loyalty members exceeded 120 million, up 50 million compared to the first quarter of 2017. Member sales represented 38% of our sales, up from 23% in Q1 2017. A year ago, we launched preorder service. In the first quarter of 2018, it reached 20% of our sales, and customers appreciate the convenience that we offer. Directionally, we are shifting towards digital and content marketing, leveraging on our membership base. We will continue to explore ways for more targeted marketing and identify cross-selling opportunities.

Delivery continued to be a key sales growth driver. In Q1 2018, delivery represented 14% of sales, up 39% year-over-year. Over 3,300 stores across 970 cities now offer delivery services. We also expand our delivery for breakfast and late-night dayparts.

KFC Prime Delivery was launched in Q4 2017, which offers our members unlimited free delivery for 30 days at a subscription fee of CNY 18. An increasing number of members signed up during the quarter, although it's too early to share any meaningful trend at this stage, we are hoping that it will uplift frequency in the long run. We are proud of KFC's strong fundamentals, and we'll look for opportunities to grow from strength to strength.

Slide 9 explores some of these ideas. First, breakfast. This daypart has been growing very fast since 2017 as we offered exciting food choices and increased the convenience through preorder. We will continue to drive growth from this daypart. Secondly, coffee. Freshly ground coffee is now available in our stores nationwide. Our key task is to build up consumer awareness through our 5,000-plus restaurants and our digital marketing campaign, together with the product innovations and effective in-store execution. Third, expanding our dessert category. Matcha chocolate ice

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cream was launched during the past quarter and more new flavors are in the pipeline. As of March, we have over 800 dessert kiosks, including stand-alone ones, 200 more than the same period in 2017.

Next, I would like to change gears to discuss Pizza Hut's overall quarterly performance. Please turn to Slide 10. In the first quarter of 2018, Pizza Hut same-store sales declined 5% year-over-year, and system sales were down 1% compared to the same period last year. We maintained our new build number of 41, flat compared to the same period last year. Restaurant margin and operating profit were down year-over-year, primarily attributable to sales deleverage and investment input. Jacky will discuss these further later on. I would like to point out that we are still continuing the journey of revitalization, and that some of the challenges we are currently experiencing will eventually be alleviated as we continue to make efforts to rejuvenate this brand.

As you will appreciate, Pizza Hut is already in the biggest casual dining -- we are already the biggest casual dining chain in China, with over 2,200 stores. With such a big scale, there will be no overnights quick fix, and it will take time for the fundamentals to be improved. Therefore we need to work relentlessly to get the right combination, including food offering, value proposition, service quality, SKU complexity and a good mix between delivery and dine-in.

Having said that, despite some setbacks, we have observed some initial encouraging results in selected markets where we tested, and we will continue to test many of our new ideas. It has given us confidence and encouragement. We need time to carry through and implement those effective measures to all the markets. We also need to fine tune the business model for both delivery and dine-in.

Turning to Slide 11, which is a review of our initial efforts on food. In Q1, we launched 3 new pizzas: 9 in 1 Pizza in January, Abalone Pizza in February and 4 in 1 in March. These were bold attempts on food innovation. Unfortunately, performance was below our expectations. Our consumer intelligence show that these products were a bit too niche and, consequently, did not have enough mass appeal across the country at all city tiers. Price should also be competitive with -- while managing the value-for-money perception. We also need to strike a good balance between product innovation and operational efficiency. We have strengthened the innovation pipeline and product testing mechanism which will be gradually rolled out through 2018.

Turning to Slide 12, a quick review of our digital efforts. We are pleased to report that Pizza Hut has over 40 million members by end of Q1 2018, up from 20 million compared to the same period last year. We have been testing different types of offers to entice our members. It increased member sales to 46% from just 5% in Q1 last year. The Pizza Hut Super-App was launched in July last year, and has already accumulated 9 million downloads. During the past quarter, delivery accounted for 23% of Pizza Hut sales, up 26% year-over-year. Over 2,100 stores now offer delivery services, up from 1,900 compared to Q1 2017. We will continue to strengthen our delivery business through own channel to ensure good customer experience and build our brand in the long term.

Turning to Slide 13. Fundamentals, digital, delivery and multi-format stores are the 4 pillars of Pizza Hut's revitalization. During the quarter, we will -- we have tested many ideas and will continue to test and stay focused to revitalize Pizza Hut. Our top priority is food, and we will continue to focus on our food. As discussed earlier, we launched new products and learned some lessons during the past quarter. We need to focus on food that taste good and offer value for money across high and low-tier cities, balancing product innovation and operational efficiency. We are also enhancing our digital capability by expanding and engaging our user base. We will continue to add new functions in our app, such as table-ordering and online-queuing to improve the customer service. This will potentially have a positive impact on our labor cost in the long run. We will continue to drive growth in delivery through our own channel and aggregator, optimizing the course as we expand geographically and increase traffic density.

Last but not least, we will continue to experiment with new formats. We are rightsizing different store formats to cater for different occasions, locations and needs. In Q1, 1/3 of our new builds are in bistros or small-store formats. We maintained store remodel's pace, and we will continue to update our store design in 2018. All in all, there's a lot of work to be done, and management remains confident and committed to the revitalization plan and strategy.

Next, I would like to turn over to Jacky to discuss our first quarter financial results.



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

Okay. Thank you, Joey. Good morning to those calling from Asia, and good evening to those calling from the U.S. Today, I will provide you with my thoughts on our first quarter 2018 performance, and I am going to highlight some important factors for you to consider as you review the results. And before I begin, I want to quickly remind you that we adopted, on full retrospective basis, of the new revenue recognition accounting standard on January 1. All of our comparative figures in prior years have been recast to reflect the new standard, which we have already provided in an SEC filing on April 18. The accounting standard has no significant impact on our accounting for restaurant sales and net income. The 2 impacts I want to highlight are: number one, initial franchisees are now being amortized instead of being immediately recognized; and number two, revenues and costs related to transactions with franchisees are now grossed up instead of netted off. This is why our total revenues in prior periods are higher than previously reported. All the year-over-year comparisons are based on the recast numbers. With that said, let's take a look at our first quarter 2018 performance on Slide 15.

We are pleased that we achieved solid financial results in the quarter, with total revenues reaching \$2.2 billion, up 6% year-over-year; and same-store sales growing plus 3%, both before foreign exchange translation. In the first quarter alone, we opened 203 new restaurants and reached a total of 8,112 restaurants in our system. I will provide more details in later slides.

Our operating profit was \$395 million, which included a \$98 million gain resulting from the acquisition of Wuxi KFC, which we treated as a special item. Excluding this special item, our adjusted operating profit was \$297 million, down by 8% year-over-year, excluding foreign exchange. Net income was \$288 million, up 29% year-over-year, excluding foreign exchange. Finally, diluted EPS was \$0.72, up 25% year-over-year, excluding foreign exchange.

Slide 16 shows the moving parts behind the double-digit operating profit growth. Overall, our operating profit increased 22% year-over-year, excluding foreign exchange impact. Excluding special items, our adjusted operating profit declined 8% year-over-year, excluding FX. The positive drivers were same-store sales leverage and net new unit growth. Wage and commodity inflation have always been a pressure faced by our business, and thanks to the excellent effort of our HR and supply chain teams, we kept our wage inflation at 6% and commodity inflation at 1% in the first quarter. We expect wage inflation to be high single digits and commodity inflation to be low single digits for the full year.

We invest about \$25 million in food and promotion cost for Pizza Hut in this quarter. While we are fine tuning our approach in product innovation, we believe that food upgrades are the right thing to do and it will take some time to see the long-term results.

G&A expenses were up 10% year-over-year in local currency mainly due to employee salary increases and the consolidation of Daojia, which was only acquired in the second quarter last year. A task force has been formed to review our policies and processes around G&A expenses. We are actively managing our G&A expenses and working to achieve our long-term goal of a G&A growth rate lower than the revenue growth rate. And finally, foreign exchange translation contributed favorably to the performance of the quarter and positively impacted our operating profit by \$33 million. Based on the current CNY-USD spot rate versus the average translation rate we incurred for our 2017 results, this positive impact may continue in future quarters. As mentioned, the acquisition of Wuxi KFC resulted in a gain of \$98 million contributing to operating profit. The gain was due to the fair value re-measurement of our previously held 47% ownership.

On Slide 17, you will see the outstanding financial performance of KFC. KFC maintained strong sales momentum in the quarter, with system sales up 9% year-over-year and same-store sales grew 5%, primarily driven by 6% ticket average growth. Restaurant margin remained flat as compared to the same period last year driven by sales leverage and productivity gain, which more than offset food investment, promotion cost and wage inflation. Operating profit improved double digit at 21% year-over-year or 11% excluding foreign exchange impact.

Now let's move on to Pizza Hut on Slide 18. Pizza Hut experienced a bumpy quarter. Although new unit builds continued for Pizza Hut in the quarter, system sales was down 1% and same-store sales was down 5%. Negative same-store sales growth was primarily attributed to a 2% decline in transactions and a 3% decline in ticket average. Restaurant margin declined 9 points year-over-year. The key drivers were: 5 points from the food investment and promotion, 2 points from inflation and sales deleverage. As we discussed on previous earnings call and early in this earnings call, food investment is part of the brand's revitalization strategy.

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Operating profit was \$34 million in this quarter. The year-over-year decline was mainly a result of sales and margin declines. We recognize the same-store sales challenge at Pizza Hut, and this is top priority for us to turn this around. As Joey indicated, we have identified what we believe are the reasons for the decline and remain committed and confident to revitalize Pizza Hut and restore sales growth.

Now let's turn to Slide 18 (sic) [Slide 19] and talk about our development effort. Thanks to our flexible approach to development and the deployment of multiple business models, we have continued to open new restaurants across every city tier and different trade zone. We accelerated our new restaurant openings with 203 gross new units and 129 net new units in the first quarter. 67% of KFC new builds and 37% of Pizza Hut new builds are in lower-tier cities. At the end of the first quarter, approximately half of Yum China's portfolio are in lower tier cities.

At the end of this quarter, the average new restaurant pretax cash payback period for KFC maintains at around 2 years across city tiers, while the average new restaurant pretax cash payback period for Pizza Hut is less than 3 years in higher-tier cities and less than 4 years in lower-tier cities. We continue to get great sites across China for all of our brands. Our development team is what doing an excellent job of continuing our leadership position as the top restaurant developer in China. We believe that China continues to offer great opportunities for unit development, and we are uniquely positioned to capitalize on the long runway for growth. And as a result, we have increased our new store opening target in 2018 from a range of 550 to 600 to a range of 600 to 650, an increase of approximately 9% at the midpoint.

Slide 20 highlights a powerful business model of Yum China, which is our ability to generate substantial free cash flow. During the first quarter, we generate net cash from operations of \$551 million and free cash flow of \$440 million after subtracting \$111 million in capital expenditures. Our balance sheet remains strong with over \$1.59 billion in cash and short-term investments. Given our capital generation capability, we continue to utilize cash to invest into our core business, enhance our strategic position and create value for shareholders. We acquired an additional 36% interest in Wuxi KFC for around \$98 million. Upon acquisition, Yum China holds an 83% interest in Wuxi KFC, allowing us to consolidate entity with slightly more than 150 KFC restaurants. In addition, we remain committed to returning excess cash to shareholders.

A cash dividend at \$0.10 per share was made in March, and our Board of Directors declared another cash dividend at \$0.10 per share to be paid in June. We view our opportunity to continue to increase shareholder value as significant, given the long runway for growth in China, our strong cash generating ability and our position as the leading restaurant developer and operator.

With that, it would like to turn over the call back to Joey to summarize and discuss our future strategy.

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

Thank you, Jacky. We will continue the 4 key strategic priorities for our business: focus on China, strengthen core business, drive value from digital and delivery and be innovative. In an internal company event in March this year, with over 8,000 restaurant general managers gathered in Shanghai, I shared with my team the vision for Yum China, which is to become the world's most innovative pioneer in restaurant industry. In this time where consumers and competitors are constantly evolving, we need to be agile and adapt quickly in order to stay ahead. We need to pioneer, innovate, stay ahead of our peers to continue to win in China.

At Yum China, we emphasize our RGM#1 culture. RGMs are one of the most valuable assets, managing more than 8,000 restaurants. On March 27, with pride, we announced that we will be offering eligible RGMs additional supplemental insurance coverage for family members, including critical unit insurance plans for their elderly parents up to 75 years of age. The RGM Family Care Program, which had been designed to benefit around 17,000 children, spouses and parents of our RGMs, will be made available from second half of 2018. This is the second stage of our 3-year program which started with granting restricted stock units to qualified RGMs. We believe that by providing a good safety net to our RGMs, they will be able to create more value for our shareholders.

With that, I return you to Millicent to commence the Q&A.

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**Millicent Tu**

Thank you, Joey and Jacky. We will now open the call to Q&A. (Operator Instructions) Operator, please proceed.

**QUESTIONS AND ANSWERS**

**Operator**

(Operator Instructions) Your first question comes from the line of Chen Luo from Bank of America Merrill Lynch.

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

I've got 2 questions on the Q1 result. First of all on Pizza Hut, we have seen flattish same-store sales growth for quite a few quarters, but in Q1, same-store sales declined by 5%. Apart from the less-than-expected performance of new product launch that we highlight just now, can you elaborate whether there are any additional reasons behind the same-store sales weakness and also the lessons we have learned as well as the measures we are going to take to further improve same-store sales growth for Pizza Hut. So this is my first question. And the second question is on KFC. The company delivered a very strong same-store sales of 5%, but despite the 5% same-store sales growth, the margins -- restaurant margins or OP margins for KFC business in Q1 was largely flattish. My impression is that 5% same-store sales growth should be enough to generate operating leverage to create some margin expansion. So is there any particular reason behind for the flattish margins for KFC in Q1, i.e., some additional advertising or other expenses?

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

Thank you. Let me take the Pizza Hut question and, Jacky can elaborate on the margin question for the KFC. For Pizza Hut, this is a journey, and it will take time. We are the biggest casual dining concept in China with over 2,200 stores in actually over 500 cities now, and for a business of this size, there can be no quick fix. In terms of the lessons learned and also what are we going to do about it, we have been focusing on 4 pillars in our revitalization plan, and we have done a lot of tests, and we learned some lesson. It's important to remember that not all these efforts were reflected in the recent quarter financials. In terms of area of focus, the first is still food. Our consumer intelligence showed that the products were too niche for all tier cities in China, and we need to have more mass appeal, particularly for the product in Q1. And the pricing itself, because of the niche product, is probably is not the best for managing the value-for-money perception. So these are the 2 very important lessons learned going forward. And also what else we could do better is to have better balance of innovation and operational efficiency, particularly during the peak trading period. And in addition to that, we -- what else are we going to do differently? We have started to emphasize more and more on our own channel for delivery business. This will help improve our user experience and be a stronger brand in the long term for delivery business. Also, we continue to build our store remodel, drive member sales and rightsizing the multi-format stores. We add 9 bistros during the quarter and several small stores. So we are doing -- we are focusing on these key 4 pillars to revitalize the Pizza Hut brand. Pizza Hut is a household name in China, and we have confidence in its revitalization plan. We have successfully turned around -- or revitalizing KFC brand in the last few years, and we are confident that we have identified the right areas for improvement and we have the right strategy for the revitalization for Pizza Hut. Jacky, do you want to take the...

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

Sure, yes. And Chen, on your question on your KFC margin, as you rightfully pointed out, same-store sales went up plus 5% so that's their sales leverage on margin. But at the same time, there are couple of reasons why margins stay flat versus last year. The first reason is there was the premium product, the Crayfish Burger, the stuffed chicken wings, these are all premium products. So we actually invest in product upgrade. The second reason is inflation. So commodity inflation was up 1% and then labor -- cost of labor was up 5% for KFC. And also as we mentioned earlier, there was an RGM event in quarter 1, so -- which we didn't have last year. So after considering all these sales leverage and the [positivity], it was able to offset the product investment, the inflation, the RGM event, and that's why we achieved flat in Q1. But going forward, just structurally, labor and

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rental costs are all on increasing trend. But with that said, with investment in digital, data and other technologies, and also, the efficiency will improve. So we intend to reinvest savings into our top line.

**Operator**

The next question comes from the line of Sara Senatore of Bernstein.

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

A couple questions, if I may, on Pizza Hut again. So first, it sounds like maybe the products weren't quite as broadly appealing as you wanted, and maybe value was a little bit of an issue. But I guess that seems like the feedback that you've gotten before. If you go back a few years and think about Pizza Hut when the comps initially started slowing, it was a view that maybe you're offering 5-star food at 5-star prices instead of 3-star prices. So I guess my question on that front is, is there a need for better testing in place? And alternatively, if we think about the emphasis on value, should we expect to see maybe continued pressure on that ticket if the shift is instead you go back to more of a value-focused price point? And then I have a question about the delivery channel, please.

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

Sara, thank you. For the product, we do have product testing process. But as you would imagine, after the Q1 this year, we realized we need to broaden the product testing, not only -- because we are in our office -- in Shanghai. And our focus is to -- for the Q1, we tried to have the bold trial on the more niche products. But if we look at the business portfolio, it has very wide coverage in 500 cities. So what we need to do more and better is to expand the product testing market so that we can have better coverage of our products instead of skewed to us, the top tier city, if that makes sense. For your question on the value. I believe that we can strike a balance of having value -- have the right value focused on the LTO, limited time offer, products. At the same time, because LTO is not the only thing we welcome. We also are revamping our entire menu. So we believe that there's something called the mix that we can manage between the LTO and the menu to manage the ticket average. So that's the way that we are going to go after the balance of value and ticket average. Sara, what's your question on the delivery?

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

Great. That's very helpful. And then just on the delivery, could you talk a little bit more about the shift into your own delivery channel and how you are looking to effect that change? Just in the context of, for example, KFC has very strong brand and upwards of 100 million loyalty members, and yet you still do a healthy business through aggregators. So is it possible to shift customers to your own channel for Pizza Hut? Or is it just that the aggregators are so strong in China that you always have to have a presence?

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

Thank you, Sara. Delivery grew at 33% year-on-year in Q1 2018. For KFC, our split is about 40% versus 60%. For Pizza Hut, the -- I think in the past, we have shared about 20-80. And we recognize the strategic importance of growing delivery through our own channel because of customer experience and long-term brand building. It's not easy, but we do see the delivery business through our own channel is on increasing trend during the Q1. It's not easy, but it's strategically important in the long term, so we're continuing to work on it. Thank you, Sara.

**Operator**

The next question is from Lillian Lau of Morgan Stanley.

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

I have 2 questions. First is a follow-up one on Pizza Hut. So how much -- can you share with us how much investment in turnaround in first quarter in particular? Because if I remember correctly, in fourth quarter conference call you mentioned in 2017, there were \$67 million investment in your Pizza Hut turnaround. What's the similar number in terms of definition for first Q? And also, compared to our initial target of 18 to 24 months turnaround time, are we still on track? And the second question is the occupancy rate because that's the first time in the past 2 years that occupancy rates start to increase in first quarter. Are we going to see the similar trend going forward, i.e., we don't have the leverage from rental costs?

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

Maybe I'll answer the first question. You can...

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

Yes. And then the occupancy rate. Okay.

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

Okay. So Lillian, on the pizza investment. In Q1 this quarter, we invest USD 25 million in product upgrade. So as you have heard earlier from Joey, there were some key lessons learned, so which provide us with very useful insights in terms of like consumer expectation and preference. And so we will continue to work extremely hard to overcome those challenges, but obviously, it will take some time. And as we continue our revitalization journey, fixing the fundamental and investing in food is still part of the strategy. So the cost of investment started only in August last year. So in the first quarter -- or in the first half of this year, it's more like a catch-up. So over the next few quarters, we will continue to invest in food, but we will invest moderately. So as you heard, we'll continue to be innovative, but we will also balance taste with price, value for money and operational efficiency. But I expect at least in the near term, there will be some pressure continue on our margin from our food investment.

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

Thank you, Jacky. In terms of the question of the time line, the 18 to 24 months revitalization plan is aggressive, but we are not changing our thinking at this point. We are prepared to take full measures to overcome challenges and ready to extend it a bit longer if it needs to be.

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

Okay. Next question, please, on the occupancy rate overall?

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

I think occupancy rate is -- rental -- just long term, it is an increasing trend. So there's no leverage on -- just from rental. I don't know if answered your question, Lillian.

**Operator**

We have a question from Brian Bittner of Oppenheimer.





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

I'm just still trying to actually understand what exactly happened to Pizza Hut in the first quarter because when I look back in 2017, the sales were stable and they were actually somewhat healthy. And there was really no sign that, as we went into 2018, they were going to really decelerate in the way that they did. And it happened at a time when you also made significant investments. So can you just help us better understand what happened in the first quarter? Because there wasn't a bad trend going into the first quarter, so I think we're all a little confused on what exactly occurred to drive the sales weakness in the first quarter versus what was going on throughout 2017.

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

Thank you, Brian. We have reviewed the sales pattern and the numbers. The number one reason is the LTO for now. Because during -- we can see the traffic has slowed down a little bit going to the Q1, and traditionally, it was very much driven by the few LTOs. And as I mentioned earlier, the LTOs, we have gone a little bit too far in terms of the food taste and also the value for man value-for-money perception. So now we have learned to pull back a bit. At the same time during Q1, we are still working on preparing the menu revamp, means other than the LTO, the rest of the products. And the rest of products were not launched until April 23. So the Q1, our focus was pretty much driven by the LTOs, and unfortunately, the 3 pizzas were below our expectations. And Q1, there was the Chinese New Year. It's a very intense period of trading. So we try our very best to adjust our product very quickly operationally, but there's obviously more to be done in the longer term.

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

Okay. And do you have a way of tracking how the full-service dining sector in China is performing? Is the overall sector for full-service dining relatively challenged?

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

I would say that casual dining concept in China is very competitive compared to QSR. QSR, we have very good -- our competitive price point on KFC around CNY 30 means very, very competitive. When we move to casual dining, the ticket average move to CNY 50, CNY 60. That's the area -- the competition is not only from other Western casual dining but other Chinese casual dining as well. So it is a very competitive area indeed, but we are confident with our [sealed] focus area that we are working on, we can be very competitive in the long term. But in addition to that, we -- the management team at Pizza Hut, we started to integrate Pizza Hut Home Service and dine-in business in the second half of 2017. That complicated our turnaround effort a bit more. We completed the integration of brand management and operating team of 2 business now. It's now under 1 logo and 1 brand. On the cover page of our presentation, that is the new logo, and the Chinese logo is new as well. The calendar is fully synchronized, and majority are manually integrated. We have more integration of riders and aggregators to do. It takes time to optimize the store network remapping. We continue to evaluate the store unit economics and develop smaller store formats. But the integration bit complicated the revitalization plan. I hope that answers your question, Brian.

**Operator**

The next question comes from the line of Xiaopo Wei of Citigroup.

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

The first question for Joey. We noticed that KFC was very strong in the first quarter. Even yourself mentioned that is -- KFC had a very high lapping in 1Q. The same-store sales, the 5% is quite an upside surprise to us. So what thing -- what do you think is surprising you on the upside in operation in KFC? That's question number one. Number two question for Pizza Hut. You mentioned that you made bold trials but learned lessons. How do you think the lessons you learned in the first quarter will be applied to the rest of the year, i.e., shall we expect that the margin pressure in the next few consecutive quarters will see less pressure versus the first quarter?



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

Thank you, Xiaopo. For the KFC, the upside, the strong lap, we -- it's -- it was always a very exciting period of time for Chinese New Year for both business, particularly for KFC, because it's such a short but intense period of time, and we try our very, very best. And I think I'm very happy to see that the marketing program resonates very well with consumers. What was also very encouraging is we -- not only we can do national marketing in a very effective way, but our regional marketing, our local marketing in each of our 17 markets, they are doing so well as well. And the particular focus on the cooperation with the China National Museum to bring the Chinese -- the exhibits. In Chinese we call it (foreign language) the national treasure come home and enjoy the Chinese New Year with our customers. That just resonates very, very well. So more learning going forward is to go back to our tradition while make it modern and interesting for our young customers. For our Pizza Hut bold trials, we certainly learned a lot, and we certainly are learning everything we could and use it for the rest of the year in Pizza Hut revitalization. And in terms of the margin, as Jacky mentioned, we'll continue to invest in food, but at the same time, we will have other measures to mitigate the impact on the margin as well. And as I mentioned earlier, it is a balance between the LTO and the permanent products on the menu. It's the mix that we can play to manage that as well.

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

Thank you. I'll just supplement what Joey just said on the margin pressure question. So for the second half, we believe investing in food is the right strategy, so we'll continue to invest in food. But like I said, we'll be smarter. So we'll be continuing to be innovative, but we'll also balance price, value for money, et cetera. But I just want to quickly point out one thing. Just during Chinese New Year, there was another lesson learned, it's that the labor hours were not just tiny but sales performance was below our expectation. So we have adjusted the labor matrix of the Chinese New Year, so the efficiency actually has shown slight improvement. So we will continue to invest in digital and technology in Pizza Hut to help improve efficiency of our crew. So hopefully in all these -- the labor initiatives would ease the pressure on margin. But overall, our priority is just continue to drive sales.

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

And the other, Jacky, sure, I have follow-up on Pizza Hut and margin. We remember that other investment in Pizza Hut that started from the second half of next last year, meaning that, the comp base for the margin will be normalized in the second half of the year. Is that right understanding?

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

That's right. You are exactly correct. So we -- the first half of this year is more like a catch-up right now. It will normalize in the second half.

**Operator**

(Operator Instructions) The next question is from Matt McGinley of Evercore.

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

On the increase in the ownership in Wuxi, why was now the right time to increase your equity ownership? And what impact will that have in the financials into the back half of the year? And I guess, specific to those unaffiliated partners, will we see this as a bigger part of your cap or cash use on a go-forward basis? And on a unit growth, what gave you the confidence to increase that unit growth by 50 units this early in the year? Does it have anything to do with the acquisition of Wuxi? Or is this increasing unit count on (inaudible) for that?



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

Matt, I'll take the first question on investment in Wuxi. This is part of our capital allocation strategy. So yes, multiple ways we can create value for shareholders. And obviously, there's organic growth like investing into our core business, also in organic growth by M&A. So buying back our JV ownership, that's part of the capital -- overall capital allocation strategy. So we spent about \$98 million in buying back Wuxi KFC, which are -- it has about 157 KFC restaurants. So by consolidating all these entities since quarter 1, there'll be a positive impact on our top line for sure, so it will help our company sales. Roughly -- KFC right now has over 5,500. So consolidate additional 157 restaurants. Just in terms of the new builds, maybe I'll answer first and then Joey can just elaborate as well. So it is also part of our strategy. I mean, it's just growing organic growth, but building additional 50 restaurants, that's our target -- revised target for 2018. But we don't chase after a specific number or target. So we build one store at a time, but the more we can expand on new store development, we will definitely expand. So -- and that's always our priority. So and we can't accelerate new builds, for example if there's a good location or there's a good trade zone, then we will jump at it, for sure. So but ultimately, if you look at returns, and as such, we are getting good returns. The brand momentum is good. We will continue to build. And so given KFC has same-store sales growth, and also there was some pipeline [does enrich] -- and 50 -- store increased in our target is all related to KFC.

**Operator**

Your next question comes from the line of Anne Ling of Deutsche Bank.

**Anne Ling** - Deutsche Bank AG, Research Division - Regional Sector Head of Asia Consumer and Media Research

Just a follow-up question on the acquisitions. I understand that there are some other affiliates which is currently owned by Jin Jiang which is another Asia-listed company. So is there any chance you might be adopting more aggressive like capital allocation strategy acquiring the other investment? And for the Wuxi acquisition, when did you acquire it? And also, just wanted to check like for the first quarter, how much did -- what is the benefit from the acquisition in terms of the -- earnings-wise?

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

Anne, I'll answer your question. So yes, after acquiring the Wuxi, there still are another 2 JVs that we can acquire, but that's an ongoing process. So I mean, at this point, there's nothing in the pipeline. So but in terms of Wuxi, we acquired that in mid-February, so on February 14. So we consolidate that for about half of the quarter. And the contribution of the top line was about 1.5%.

**Anne Ling** - Deutsche Bank AG, Research Division - Regional Sector Head of Asia Consumer and Media Research

Okay. And do they have a similar margin?

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

Yes. More -- the margin is more or less the same for all of our KFC restaurants.

**Operator**

The final question is from Michelle Cheng of Goldman Sachs.

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

My question is about the guidance. Since we earlier had 2018 operating profit growth guidance of double digits, and can I confirm this excludes this one-off? And given the year-to-date performance, do we still see this double-digit operating margin growth still intact?

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

Yes. Michelle, we are committed to our long-term -- just the ongoing financial target. So I mean, the first priority right now is just to turn around or revitalize Pizza Hut. So we want to turn around the same-store sales growth, improve margin for Pizza Hut. And then, as far as we can, yes, maintain healthy same-store sales growth for both brands, then we do have a positive impact on our operating profit. And we will also strive to just improve our efficiencies to offset inflation. So overall right now, we are very committed to all of these ongoing financial targets. But there may be fluctuations quarter-to-quarter or year-on-year.

**Operator**

There are no further questions at this time. I would now like to have the conference back to today's presenters. Please continue.

**Millicent Tu**

Thank you, operator. Ladies and gentlemen, with that, we conclude the call. Thank you very much.

**Operator**

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

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