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YUMC - Q3 2018 Yum China Holdings Inc Earnings Call

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## PRESENTATION

**Operator**

Ladies and gentlemen, thank you for standing by, and welcome to today's Yum China 2018 third quarter earnings conference call. (Operator Instructions) I must advise you that this conference is being recorded today, Wednesday, the 31st of October 2018. I would now like to hand the conference over to your speaker today, Millicent Tu. Thank you. Please go ahead.

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**Millicent Tu** - *Yum China Holdings, Inc. - VP of IR*

Thank you, operator. Hello, everyone, and thank you for joining Yum China's third quarter 2018 earnings conference call. Joining us on today's call are Ms. Joey Wat, CEO of Yum China; and Jacky Lo, CFO of the company.

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

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

Today's call includes 3 sessions: first, Joey will cover Yum China's third quarter 2018 highlights; and Jacky will cover the financial results; we'll then open the call to questions. A webcast of this call will be available on our IR website. A PowerPoint presentation which contains operational financial information for the quarter is available for download. Please note that the presentation has been provided for reference, and does not correlate directly to management's prepared remarks on today's call.

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

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

Thank you, Millicent. Good morning, good evening, everyone, and thank you for joining us today. First, I will give an overview of the quarter before providing greater detail on our operational initiatives in each of our core brands.

In the third quarter, we delivered solid system sales growth in the context of softer trading conditions and greater competition. We accelerated new builds to systematically expand our footprint in both high- and low-tier cities. We drove traffic by launching a range of value initiatives, introducing innovative products and improving offerings in high-growth dayparts. And we continue to build out our digital, data and delivery ecosystem to make it easier to dine at our core brands and create a sustainable platform for growth. KFC, our biggest brand, recorded healthy sales growth, particularly in Tier 1 cities, thanks to strong brand recognition, excellent execution and first-mover advantage. While Pizza Hut sales remained under pressure during the quarter, we effectively managed the Pizza Hut restaurant margin as we optimized our investments in new products and improved labor productivity.

We also made further progress on the Pizza Hut revitalization as we launched a refreshed brand identity, improved our value proposition, expanded our digital capabilities and generated greater delivery traffic through own channels.

Now I will provide some more color on the performance and strategy of our key brands, starting with KFC.

KFC is our primary growth engine and the #1 quick service brand in China. KFC continued to perform well, with positive same-store sales growth in the third quarter on top of 10% same-store sales growth in the same quarter last year. With a 2-year cash payback period and the development opportunities across all city tiers, expansion continues to be a key priority.

During the quarter, we accelerated new builds across all tiers in China with a near-term focus on the high-growth region in the Yangtze corridor. KFC is currently in 1,200 cities across China, and we are tracking a further 1,000 smaller cities. This is why we believe in the potential to grow to 20,000 stores over the long term for all of our brands in China.

In addition to expanding our portfolio, we continued to implement a range of initiatives to drive same-store sales growth. These include new promotions focused on value, expanding new dayparts and product categories, and enhancing our digital and delivery ecosystem to increase engagement across every part of the customer journey.

Let's take a look at our progress in these different areas. We launched Crazy Thursday in August 2018 to promote selected products at a very attractive price point of CNY 9.9. This program succeeded in driving additional traffic to KFC, and we will extend it through the rest of the year. We also continued to enhance our breakfast, coffee and dessert offerings, which are important growth levers for same-store sales. While breakfast has a lower price point, it is a fantastic way to increase frequency and build the habit of coming to KFC. We have continuously evolved our breakfast menu with new products such as Chinese pancake, da bing, and waffles and upgrade the existing products such as panini with higher quality ingredients. We continue to focus on speed, convenience and value by expanding our breakfast privilege offering and extending breakfast hours to cater to different customer habits. We also boosted the value perception by offering breakfast combos priced at CNY 6, CNY 7, CNY 8 and CNY 9.

In terms of product categories, we are particularly excited by the potential of coffee. Since we upgraded our coffee offering with better machines and beans back to 2015, we have experienced very strong growth. In the first 3 quarters, we recorded double-digit growth and sold 63 million cups of coffee, making us one of the biggest coffee retailers in China, and we expect coffee sales to exceed CNY 1 billion by the end of 2018. We also recently launched sparkling coffee, which was very well received, particularly by the younger customers. With competitive pricing and a coffee privilege program, we are confident that coffee will continue to grow.

Dessert is another exciting category, and we have invested in high-quality, trendy products at great prices to create a really distinct offering. In the third quarter, we launched 3 ice cream flavors and selectively added waffles and milk tea at some locations. We also continued to roll out more dessert kiosks. At the end of the quarter, there were over 1,000 kiosks across China, up from approximately 800 in the same period last year.

Now turning to digital, data and delivery. These are having a transformative impact on the restaurant industry in China. In the future, the leaders in the restaurant industry would seamlessly integrate online assets with offline stores to create a holistic experience for customers.

We are focused on achieving this goal, and we are investing in all 3 areas to build a sustainable platform for growth. We are a digital pioneer and have created a powerful digital ecosystem centered around our Super App. This enables us to engage throughout the customer journey from before a customer enters our stores, while they are in-store and after they leave. It also enables us to better understand our customers, implement more targeted marketing campaigns and improve frequency of our loyalty members.

By the end of the third quarter, we had over 145 million KFC digital loyalty members, with member sales accounting for 44% of total sales. 80% of payments are now digital, which we previously referred to as cashless payment. One of our key digital loyalty initiatives is the KFC privilege subscription program, or basically pay members -- paid membership illustrated on Slide 10 of the presentation, which is designed to increase order frequency and customer loyalty. We have created 4 privilege programs to cater to different customer preferences such as delivery, coffee and breakfast.

Taking delivery privilege as an example, initial results showed that order frequency has meaningfully increased during the subscription period, and delivery privilege member sales accounted for over 10% of delivery sales through KFC-owned channels in the third quarter.

Delivery is also a key sales growth driver as it enables customers to dine wherever and whenever they want. We collaborate with aggregators to source delivery orders and fulfill all orders using our dedicated KFC riders. In the third quarter, delivery represented 14% of sales, up 2 percentage points year-over-year. 70% of our KFC stores now offer delivery. We are working on initiatives to fuel the next stage of delivery growth, including growing underpenetrated dayparts and categories, improving rider efficiency and expanding the delivery privilege program.

Looking ahead, with new store cash payback in 2 years and multiple store formats to suit different locations and customer behaviors, we have plenty of room and flexibility to open more KFC stores across all city tiers. You can see a few of our new store formats on Slide 12. We remain very excited about KFC's growth potential.

Next, I will provide some color on Pizza Hut's performance.

Pizza Hut is the leading western casual dining brand in China and represents around 20% of our business. Sales were down during the quarter as softer trading conditions and a more competitive environment led to underperformance at the dine-in segment. However, we continued to make progress with the Pizza Hut revitalization program, and we are starting to see positive feedback from our customers.

We recently introduced a refreshed brand identity for Pizza Hut, repositioning the brand as a trendy, family-oriented, value-for-money, casual-dining concept centered around the tagline, "always something new." The refreshed brand includes a redesigned logo, modern store fit outs and exclusive new uniforms designed by leading fashion designer, Anna Sui. We are confident that this will help to shape the legacy perception of the brand and enable us to better connect with our target customers. The revitalization program, which is focused on 4 pillars: fixing the fundamentals, enhancing digital, optimizing delivery and introducing new store formats, is also gaining traction.

First, let's look at digital. Pizza Hut has come a long way with digital over the past 12 months. Digital is a critical enabler for the business and it will help us understand our users better, serve them faster and in a more personalized manner. By the end of the quarter, digital members exceeded 50 million, up from 30 million at the end of third quarter 2017. Sales from members accounted for 43% of third quarter sales compared to 25% in the same period last year.

In July 2018, we launched in-store table-side ordering, which enables customers to order by scanning a QR code with their mobile. This initiative improves ordering speed and reduces the workload of table staff, particularly during peak hours. This service is now available in 1,500 stores and accounted for 6% of the store sales in the third quarter. One example of the power of digital and data is the recent insight that we gained from our CRM.

Based on our analysis of buying trends, we realized that when young customers are a growth demographic, families contribute a meaningful portion of our sales. Using this insight, we are now testing the Pizza Hut family privilege membership program and strengthening our offering for children.

Turning to the delivery. Over the past few quarters, we have focused on integrating the dine-in and home service brand, and increasing orders through our own channels. I'm pleased to report that we are making good progress in both these areas, with delivery accounting for 25% of Pizza Hut sales, up 4 percent points year-over-year. The integration is close to complete and we recorded double-digit growth in delivery sales from our own channels in the third quarter.

We are also increasing the proportion of orders that are delivered by our dedicated riders. This gives us greater control over delivery quality, improving our ability to deliver during peak hours. During the quarter, our dedicated riders delivered approximately 55% of our orders already.

We also recently rolled out delivery privilege for Pizza Hut and will continue to improve the delivery menu and packaging and optimize system and trade zone mapping to improve efficiency.

Next, let's look at the fundamentals. When we started the revitalization process, we realized that the menu was too large and that we needed to improve our product offering and value perception. We have made a lot of progress on these fronts.

We have significantly simplified the Pizza Hut menu by around 25% from 120-plus SKUs to currently 80 to 90. This has improved restaurant efficiency and make it easier for customers to navigate our menu. We have revamped over 70% of our menu using a systematic approach that involves testing new products through limited time offers and then adding the most popular products such as Durian pizza to our permanent menu. To cater to different customer preferences, we launched the Italian handcrafted pizza in the third quarter and now have 4 types of doughs, reinforcing our Pizza Hut pizza expert image.

We also continued to launch buzzworthy products to attract consumers and rejuvenate our brand image. During the third quarter, we made great progress in the desert and drinks categories by launching salty egg ice cream, summer cocktail smoothies and so-called Dirty Series desserts in key cities in Eastern China. Some of these exciting new products are featured on Slide 16 of the presentation. We are also addressing the value perception at Pizza Hut by increasing size without charging more and introducing attractive entry prices for popular products and in delivery. These initiatives are starting to translate into a better perception of Pizza Hut. Our latest brand tracking shows that scores for good taste, always something new and value for money have improved in the third quarter compared to the past 2 quarters, particularly in tier 1 cities.

Lastly, we are optimizing our portfolio through remodels and multiple store formats. Our newer format such as the Pizza Hut bistro, small store and express are smaller footprint stores that are designed to address the diversified dining requirements of customers in different locations, improve efficiency and better support delivery needs. In order to provide a more comfortable and fashionable dining environment, we are also accelerating the remodeling of our existing portfolio. We plan to remodel around 250 stores in 2018, continue to pace up in 2019 and complete the refresh by 2021. To minimize CapEx and closure time, we will partially remodel store interiors. We are confident that this will improve the attractiveness of our portfolio.

Before I turn the call over to Jacky, I would like to briefly mention our new standalone coffee concept, COFFii & JOY. In the past few months, we have opened 6 COFFii & JOY stores, adopting 3 different formats in Shanghai, Nanjing and Hangzhou to test demand and preferences. We are still at the very early stage of this concept but have been pleased by the progress so far. We will provide further detail on our findings and plans for the concept in the coming quarters.

With that, I will hand over the call to our CFO, Jacky Lo, who will cover our financial performance in more detail.

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

Thank you, Joey. Good morning to those calling from Asia, and good evening to those calling from the U.S.

Total revenues reached $2.2 billion in the quarter, up 6% year-over-year excluding foreign exchange translation. Total system sales grew 4% year-over-year in the third quarter of 2018, excluding foreign exchange translation, primarily due to accelerated new store openings. We have opened 195 new stores during the quarter, of which over 70% were KFC stores.

In the first 9 months of the year, we have opened 562 new stores, up 30% comparing to the same period last year. Our portfolio exceeded 8,300 restaurants as of the quarter end. During the quarter, KFC year-over-year system sales grew by 6% while Pizza Hut system sales declined by 2%.

Yum China same-store sales declined by 1% in the third quarter of 2018, with KFC same-store sales grew by 1%, lapping a 10% same-store sales growth in the prior year; while Pizza Hut same-store sales declined by 5%, largely attributable to the impact of softer trading conditions and underperformance in the dining segment.

During the quarter, KFC ticket average increased by 3% year-over-year due to continuous product innovation and upgrades, while traffic decreased by 2% year-over-year, a smaller drop comparing to the second quarter. Pizza Hut ticket average decreased by 4% year-over-year due to increased promotional activities and value campaigns. Although traffic declined by 1% year-over-year, it's an improvement as compared to the previous 2 quarters. While sales remained under pressure, we are starting to see a more positive traffic trend as the revitalization initiatives take effect.

KFC restaurant margin was 19.2% comparing to 19.6% for the same period last year, primarily due to inflation, product investment and promotions, which were partially offset by labor productivity gains and savings in other COGS. We were pleased with the Pizza Hut restaurant margin, which was 13.8% in the third quarter comparing to 14.4% in the same period last year. We effectively managed restaurant margin through labor efficiencies and optimization of food investment at $12 million in this quarter as compared to $15 million in the second quarter and $25 million in the first quarter of 2018.

Overall, Yum China restaurant margin was 17.6% comparing to 18% for the same period last year. For the third quarter of 2018, wage inflation was up 6% while commodity inflation was up 2% as compared to the same period last year. We expect wage inflation to maintain at high single digit and commodity inflation at low single digit for the full year.

After a 22% year-over-year decrease in G&A expenses last quarter, we recorded another 2% decrease in this quarter ex FX. The decrease came from a mix of one-off benefits and ongoing cost control. We'll continue to review our overall cost structure, policies and processes around G&A cost to identify opportunities for savings. Our long-term goal remains to maintain a G&A growth rate lower than the revenue growth rate.

Operating profit for the third quarter of 2018 increased by 4% year-over-year ex FX. Factors such as net new unit growth and G&A expense improvement make a positive impact on operating profit while same-store sales had a deleverage impact in the quarter. For the third quarter of 2018, KFC operating profit improved by 4% year-over-year ex FX, while Pizza Hut improved operating profit by 1% year-over-year ex FX. Due to the depreciation of renminbi against the U.S. dollar, foreign exchange translation negatively impacted our total operating profit by $4 million during the quarter. Such negative impact may continue in the fourth quarter of this year.

Our effective tax rate was 24% in the third quarter of 2018, 8 percentage points lower than the same period last year due to the reversal of certain U.S. tax provisions we previously made on global intangible low tax income earned by foreign subsidiaries and also less estimated repatriation of current year earnings outside of China. Finally, diluted EPS was $0.51 in the third quarter of 2018, up 18% comparing to the same period last year ex FX.

Our new unit returns remained stable. Across all city tiers, the average new restaurant pretax cash payback period remains 2 years for KFC and 3 to 4 years for Pizza Hut. We are confident to achieve our new store opening target of 600 to 650 in 2018, led by KFC and our expansion into lower tier cities.

2018 full year operating CapEx is expected to be $450 million to $500 million. 699 stores were remodeled in the first 9 months, an increase of 30% compared to the same period last year and 209 of those remodels came in this quarter. With the rollout of partial remodeling, we are able to invest more flexibly and reduce closure time.

Next, let me cover our capital allocation strategy. In the first 9 months of the year, we generated net cash from operations of $1.17 billion and free cash flow of $814 million after subtracting $359 million in capital expenditures. Our balance sheet remains strong with over $1.53 billion in cash and short-term investments. With our healthy cash position, we returned $132 million to our shareholders, including a cash dividend of $38 million and common stock repurchases of $94 million in the third quarter.

In the first 9 months, we returned $282 million to our shareholders, including cash dividends of $115 million and share repurchases of $167 million. Creating value for shareholders has always been our top priority. I'm glad to report that we received board approval to increase our quarterly cash dividend by 20% to $0.12 per share. In addition, we'll increase the existing share repurchase authorization by $850 million to $1.4 billion in total. As of today, the company has repurchased approximately 11.3 million shares for $406 million, including 3.4 million shares for $110 million in October 2018. There's approximately $1 billion remaining under the new share repurchase authorization. These 2 measures reflect our confidence in our business model and our ability to generate cash.

In this quarter, we also invest $74 million in Meituan Dianping's ordinary shares during this IPO process. The equity investment is part of our delivery business growth strategy. We measure the investment at fair value on a recurring basis, which is subject to market price volatility. So let me turn it back to Joey briefly before we open up the call to questions.

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

Thank you, Jacky. So to sum up, KFC continues to perform well and is supported by strong brand recognition, excellent execution and first-mover advantage as we grow our portfolio across all city tiers. We are also encouraged by the positive feedback we are receiving around the revitalization program for Pizza Hut with a fresh new identity, new menu and store format to better connect with customers.

While we expect Pizza Hut sales to remain under pressure in the fourth quarter, and it will take time to see the full impact of these reforms, we are confident that we have the right strategy in place to revitalize the brand and return it to growth.

With urbanization, growing disposable income and loan penetration in lower tier cities, the long-term fundamentals of the China opportunity remains unchanged. We will continue to invest in profitable growth for our core brands to strengthen our leadership in China's restaurant industry.

With that, I'll pass you back to Millicent to start the Q&A.

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**Millicent Tu** - *Yum China Holdings, Inc. - VP of IR*

Thank you, Joey. We now open the call for questions. (Operator Instructions) Operator, please proceed.

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## QUESTIONS AND ANSWERS

**Operator**

(Operator Instructions) And our first question comes from the line of Brian Bittner.

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

Two questions, 1 on Pizza Hut and then 1 on the capital allocation strategy. On Pizza Hut, you referenced the softer trading conditions this quarter. Can you just elaborate a little bit more on what you mean by that? And how is the confidence that Pizza Hut's not facing some secular headwinds that may make it a little more difficult to turn around despite the initiatives you're putting in place?

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

Okay, all right. Let me -- thank you, Brian. Let me share a few thoughts about the softer trading conditions. We can certainly provide some thoughts into the trend that we are observing. First is consumer. Consumers are increasingly looking for better value and better -- and bigger savings. And we have seen a slowdown in foot traffic for the dine-in for Pizza Hut but at the same time, delivery continues to grow. Number two, in terms of competitor, we have also seen an increase in competition with more store openings in mid-, low-tier cities and also intensified promotions in higher-tier cities. Fortunately, we have a lot of experiences and competitive advantage compared to our peers. For Pizza Hut, we are the market leader in the western casual dining segment with excellent brand recognition. We have -- also have a very good nationwide supply chain and we have a very good development team to continue the growth. In terms of whether it will be a headwind, the future of the restaurant business, both in QSR and in casual dining, is a balance of the online and offline experience for customers. So we -- as we start the revitalization program last year, we have made very good progress in digital, the online experience, and we continue to make progress in there such as the tableside ordering as I mentioned earlier. But on the offline side, in the store, it's also very important to improve the store assets and the great experience. And the stores, let's not forget the stores, are the enabler for the offline business. So we see the combination of the improvement in both areas and we see long-term opportunity for the Pizza Hut business as well. I would like to make one last comment on this one before I guess, you can answer the capital question is in the long term, we are committed to China and for KFC, we always mention that we're in 1,200 cities but we still have 1,000 cities in China that we don't have a KFC. For Pizza Hut, right now, we are only in 500 cities in China. So that means there are 1,700 cities in China that does not have Pizza Hut yet. So in the short term, obviously, we see the bumpiness. But in the long term, we believe the opportunity, the fundamentals are still very good. So maybe you can ask the capital question, Brian.

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

Yes. And thank you for your Pizza Hut answer, I appreciate it. It was really intriguing to see the increase in the share repurchase authorization and it sounds like you have around $1 billion left. Over what timeframe should we assume that you plan on using that authorization? If there' is any help you can give us on how to think about annual share repurchases that you're targeting, that would be super helpful.

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

Yes, Brian, well, obviously we are very confident in our cash generating ability, that's why we work with the board to increase the share buyback authorization. And our share buyback decision is always based on a number of quantitative and qualitative factors. And we have always been opportunistic when we execute a share buyback plan. So I mean, to put it into better perspective, so in the last 18 months, we repurchased over $400 million but over $275 million came in the last 6 to 7 months. So I mean, we just -- from our perspective, share repurchase is an ongoing commitment and just we will continue to execute the plan opportunistically. And I think the expansion of the authorization clearly shows our commitment in returning value to our shareholders. So we don't have a timeframe to put on that, but we will just continue to execute the plan as we used to.

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**Operator**

And our next question comes from Sara Senatore.

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

I had a quick follow-up question on sort of unit growth and then I wanted to ask about the coffee prototype. So the first is just you slowed Pizza Hut pretty dramatically but KFC has accelerated. And so year-over-year, your whole system is roughly stable in terms of growth versus last year. So I was just wondering if there's sort of a target that you have to achieve, whether it's because you want to be -- you have something set out with your agreement with Yum!, or does it just kind of work out that way? Because it feels like KFC has kind of just perfectly offset the slowdown in Pizza Hut and I was trying to understand whether that's something that would persist if the Pizza Hut returns continue to be under pressure. So that's my first question, just a follow-up, and then I wanted to ask you about the coffee initiative. Obviously, we've heard about a lot of new entrants in that market and accelerated growth from some of the global brands like Starbucks or Costa. And I was just wondering maybe if you could talk about the competitive dynamics in that market, and what sort of attracted you to enter now.

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

Thank you, Sara. Let me start with the unit growth. We don't have a specific target for the new unit growth. We -- what we want to achieve is profitable growth for the core brands. So let's start with the Pizza Hut -- KFC, and then I'll talk about Pizza Hut. For KFC, we are already in 1,200 cities and it covers a range of top-tier to lower-tier cities. And the dynamic in the top-tier versus lower-tier cities is quite different. So if I could use the way to describe it, it's a 1 country, 2 strategies. So in the top-tier cities, our focus has been driving same-store sales. We are opening stores but even for Q3, we can see we drive very healthy same-store sales with the offers, the value, et cetera. And for the lower-tier cities, we are very aggressive in opening new stores because there's a lot of white space still available in both the lower tier cities we are in and in the cities where we don't even have 1 single KFC store. And again, we have seen the result of lower-tier cities right now is giving us very nice system sales growth. Even though the new store that we opened in imply sales transfer from the existing store to new store, but net-net, the system sales growth is what we want to see in lower-tier cities. So holistically, we believe that we are doing the right thing to drive both same-store sales in top-tier cities and system sales in lower-tier cities. And you can see in KFC, we have opened more stores for the first 9 months than the entire year last year, and that is driven by the economics. When we open a store, we evaluate each store what -- on each store basis, whether it makes profit, whether it satisfies a criteria of payback. And we are very happy with the 2 years -- less than 2 years payback when we open a new store. So as long as we can open stores, satisfy less than 2-year payback, we are committed to the new store opening. Now, Pizza Hut, Pizza Hut obviously, we are going through a transition and we are adjusting our business model. As you can see, we are still opening stores in Pizza Hut despite the challenges in the revitalization because it's still the right thing to do. With that said, we have adjusted our new store model. So what are the characteristics of the new stores that we have opened? First, they are more targeted toward certain customer behaviors, customer needs, locations and they are more delivery-friendly. Secondly, overall, the new stores of Pizza Hut are smaller in the -- of the old store on average, the size is about 400 square meters. The new store, on average, about 300 square meters, so it's a 25% reduction. And we believe this is a much better model to support the growth of both dine-in and delivery business going forward, with much better cost structure from CapEx to upgrading COGS, et cetera. So that's for the unit growth. In terms of coffee, my thoughts are as follows. First, we are very excited about the coffee category. We believe the coffee category has huge growth potential in China in general. And we have been excited about the coffee category since 2015 when we significantly upgraded our coffee offering at KFC. And in the past 3 years, we have seen a huge amount of growth right across China in all of our 5,600-plus KFC stores. And this year, we're going to exceed CNY 1 billion sales for KFC coffee alone. But also, we also sell coffee in Pizza Hut as well. We will continue to improve our coffee offering at our core brands. At the same time, we are exploring a new standalone concept in COFFii & JOY. As I mentioned earlier, it's still early in our process and so far, we have opened 6 stores, using different formats. And in our business, we have a very systematic way when we try different things once we produce a prototype, so we have the prototype right now. Second, we find ways. We learn how to scale it up and then we pursue the operational efficiency and excellence. So right now, we're still at the prototype stage and we're still fine-tuning the model and we will report back with more details in due course. Thank you, Sara.

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**Operator**

(Operator Instructions) And our next question comes from the line of Xiaopo Wei from Citigroup.

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

I will limit my question to 1. My question is for Joey. And in your statement in the press conference, you said that you will continue to build out a digital and a delivery ecosystem. And we understand that Jacky said that the company invested in Meituan IPO, and we also understand that Ant Finance is your -- one of your major shareholders, while Alibaba, which is related to Ant Finance acquired Ele.me this year. So I just want to ask, do we have any closer collaboration with Ele.me or Alibaba with the changed the dynamics in the food delivering platform aggregators?

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

Thank you, Xiaopo. I will share my thoughts on digital and delivery, and Jacky can mention his comments on Meituan. For digital and delivery, Xiaopo, it's really part of our holistic strategy. We do believe the future of the restaurant business is a balance of the online and offline. And for digital and delivery, we have been investing in this area since actually 2015 for KFC and then we catch up in this area for Pizza Hut since last year. We believe this is a very powerful ecosystem that we have built and will continue to build because particularly for tier 1 cities where we have a big number of stores, we see the power of data that we can learn from our customers. And we also learned from the data and then designed our marketing campaign to increase spending, to form higher visit frequency and to encourage higher participation at different categories, dayparts and even brands, even between KFC and Pizza Hut. And for our member program, our efforts include both value and experiences, so we'll continue to be committed to it. And delivery is another growth driver for both businesses right now. We have built our own channel and also, we managed a healthy mix between own channel and aggregator in terms of sourcing the traffic. And I'm happy to report that while KFC has a very healthy mix -- always has a healthy mix of traffic generated by own channel, now Pizza Hut, we are also increasing of our own traffic from own channel, not to mention the 55% riders from our own -- 55% orders delivered by our own riders. So we'll continue to push forward in both areas because this is strategically important, while the stores are enabler for both digital and delivery to form the total experience for our customers. So...

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

And Xiaopo, on your second question, I guess our delivery strategy is to work closely with our aggregator partners, both Meituan and Ele.me, just to grow our delivery sales business. So the investment in Meituan is just part of that strategy and we'll continue to invest to grow the delivery business on our own channel as well as on the aggregator platforms.

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**Operator**

And our next question comes from the line of Lillian Lou from Morgan Stanley.

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

I have a question about -- a little bit about the numbers because we saw quite a big savings from occupancy and other expense ratio for third quarter, over I think 130 bps. So basically, are we seeing this trend going to continue? And how much savings from, as Joey mentioned, the store efficiency improvement? How much from the rental cost? How much from other savings like advertisement, et cetera?

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

Yes. Lillian, occupancy and other costs, actually it includes a few components. So advertising and marketing, utility, rental, depreciation, license fee to Yum! Brands and some other restaurant-related costs. So the improvement in this quarter mainly came from 2 factors. Number one, savings in advertising and marketing expenses because we are shifting from the traditional mass media to digital and targeted marketing such as member discount, which is now recorded under cost of sales. And there are also other utility savings. We have a lot of cost-saving initiatives at the store. For example, more energy-efficient appliances and processes like optimizing water and air conditioning usage. So these are the 2 major reasons behind the decline in occupancy costs in this quarter.

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

So what about the trend? Are we going to see this sustainable in the following quarters?

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

Yes. I think we will just -- I mean, we have been doing this for many years. We will continue to optimize our cost structure, yes. It fluctuates quarter-to-quarter so -- but we'll continue to do -- to optimize the cost structure.

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

Yes, one additional point, Lillian, I would add is as we become more flexible in terms of the store format and become more sort of demanding in terms of the store size, meaning smaller store, management is becoming more efficient in our management of rental and depreciation cost, which, in the long term is helpful to our business model.

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

Yes. Lillian, also keep in mind, there's seasonality to our business as well.

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**Operator**

And our next question comes from the line of Matt McGinley from Evercore.

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

My question's on the Pizza Hut margin and how well you did in managing that cost structure to offset the -- how well you managed the margin decline relative to the comp. I guess as a follow-up in that, the food and paper margin, it was -- you rolled over investments you began to make in food quality a year ago when the margins were still under pressure. And I understand there was a little bit of an ad shift there that would've gone from the occupancy into that. But how much of that margin decline was continued investment in food or delivery growth, which I assume is a lower ticket than dine-in and perhaps, lower margin?

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

Yes. Well, Matt, on the Pizza Hut margin, well, due to the softer trading condition and the more competitive environment, which have a more prominent impact on the casual dining, so Pizza Hut faced some pressure on sales this quarter. And as Joey mentioned, we are encouraged by the progress we made on the revitalization of the brand. We also effectively managed the restaurant margin as you pointed out. We accomplished that through labor efficiencies and also, optimization of our food investment. So first on the labor efficiencies, so we have been improving the labor scheduling, optimizing the management-crews matrix and also, we are utilizing the digital capabilities. For example, like the tableside ordering, to improve the crew efficiency. And also on food investment, it includes actually both product upgrade that also, the better value to our customers like member discounts. So with the step up in the value campaign this quarter, the decline in traffic has improved comparing to the previous 2 quarters. So China was only down 1% versus 6% in the prior quarter. So obviously, the investment in food impacted margin over the past few quarters but in Q3, we only invest about $12 million, so we are doing a more targeted investment in our food. So it was $12 million versus $15 million in the last quarter, $25 million in the first quarter. But we believe the current softness in sales may continue for the remainder of the year. But with that said, we will likely continue to invest in Pizza Hut and just step up promotion activities to drive sales. Yes, but better products and value campaigns, that will put some pressure on the margins, but we are very confident with our targeted investment in food. Supported by the 4 pillars of revitalization plan, Pizza Hut will gradually restore traffic and sales.

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

And just to add a little comment on the margin for delivery, Matt. The delivery -- the food business, even with lower ticket average but with our knowledge -- well, ongoing accumulation learning about customer and delivery business, we are certainly more flexible and more targeted with our marketing investment for the delivery. So the flexibility is important in the short term for -- given the softer trading situation and for delivery business in particular.

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**Operator**

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

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

My question is for Joey. Can you help us understand over consumption environment, given from second quarter, we talked about more promotional environment in terms of consumption sentiment. But how do we look for the -- like, especially KFC same-store sales growth into the next few quarters? And will this impact our store expansion for next year? Understanding this year, we probably -- it's very easy to reach our original target, but how about next year's store expansion target?

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

Thank you, Michelle. I have mentioned my thoughts on the consumption sentiments. So just really quick for KFC consumer competitor. For consumer, definitely looking for better value and bigger savings. For competitors, we can observe the increase in competition in promotion, so very aggressive promotion from our peers. How does that impact our goal in terms of store expansion? Next year, we will stay on our course. We will look at our payback, our pipeline and we will continue to push for the same-store sales in top-tier city and we'll continue to push for lower-tier city store expansion aggressively because it just makes sense. For the new store opening, although in lower-tier city, it implies sales transfer in the short term but it also builds system sales in the short term. And in the long term, it helps our market share, it helps our brand building. Brand building and first-mover advantage is very important for KFC because it's food. The earlier we go in, that earlier we define the taste of fried chicken. And we have been doing that for 31 years successfully and we'll continue to do that. So for the store expansion next year, I will say we'll stay on the course. And for the consumption sentiment, while it's looking for better value and bigger savings, in the short term, KFC can do that. There's nothing wrong to offer something, it's a lovely term called cheap and cheerful, particularly during some slightly tougher times for customers. So thank you, Michelle.

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**Operator**

And our next question comes from the line of Chen Luo from Merrill Lynch Bank of America.

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

I've just got 1 question on Pizza Hut margins. If it -- looking at the details, the margin erosion in Q3 was more -- was all driven by the rising food and paper costs, whereas we have achieved big savings in labor cost and occupancy and other costs. So heading to next year, actually we are going to see easy laps regarding the food and paper cost. So let's assume if same-store sales still stay at, let's say, low- to mid-single-digit decline range for next year, given all the cost-saving initiatives and easy laps for food and paper cost, are we going achieve largely stable margins for Pizza Hut? Or because of the deleverage, we are still a bit cautious on the margin outlook?

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

Well, I guess, Luo Chen, we'll just continue to execute the 4 pillars and I mean, we are very confident in that. So that's going to first of all, restore traffic and sales and then followed by restaurant margin improvement. So -- but I mean, we are just taking it 1 step at a time and we'll continue to execute the 4 pillars. And once traffic is restored, sales recovers, we'll continue to work on different initiatives to drive restaurant margin improvement.

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

And Luo Chen, I mean, our team has worked very, very hard to achieve the saving or to manage the margin. But I -- in our terms, there's no such thing called easy lap. Nothing is really that easy, given the scale of our business. But we do plan to continue our focus on margin management and with the hope that in 2019, we can continue to focus on that and to have more positive improvements in terms of profit if our sales improve in 2019.

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**Operator**

And our last question comes from the line of Anne Ling from Deutsche Bank.

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

Management team, just one, like, number regarding the same-store sales trend, our same-store sales growth in third quarter. Just want to check whether the Mid-Autumn Festival will have any impact on our sales trend. Say, like if we do not have the Mid-Autumn Festival in September, what will be our same-store sales for like, KFC or Pizza Hut? Do we have this kind or it is just not important at all?

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

Anne, hi. The Festival time and weekend shift between quarters are very common and vary by brand. It's very different for KFC and Pizza Hut. We manage these shifts with our marketing campaigns, but I will add the comment that we do look at festivals as opportunities. So for KFC, we offer xiao xian rou su bing. It's a kind of moon cake for East China they love to eat to improve the customer experience. But it also helps to drive traffic and also ticket average. And for Pizza Hut, it is the first year we offered moon cake and the result of the moon cake is pleasing. So we tried something new and customer reaction was positive, and it's very likely that we'll continue to do moon cake in Pizza Hut to celebrate Mid-Autumn Festival again next year. So thank you, Anne.

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**Millicent Tu** - *Yum China Holdings, Inc. - VP of IR*

Okay. Well, thank you all for joining today's call. This concludes Yum China's third quarter earnings presentation and this call. And we look forward to speaking with you next time. Have a great day.

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

Thank you, all.

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**Operator**

Thank you so much. And that does conclude the conference for today. Thank you for participating. You may all disconnect.

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