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Q3 2022 Yum China Holdings Inc Earnings Call

EVENT DATE/TIME: NOVEMBER 02, 2022 / 12:00AM GMT

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PRESENTATION

Operator

Thank you for standing by, and welcome to the Yum China Third Quarter 2022 Earnings Conference Call. (Operator Instructions)

I would now like to hand the conference over to Ms. Michelle Shen, Director of Investor Relations. Please go ahead.

Michelle Shen ***Yum China Holdings, Inc. - IR Director***

Thank you, Ashley. Hello, everyone. Thank you for joining Yum China's Third Quarter 2022 Earnings Conference Call. On today's call are our CEO, Ms. Joey Wat; and our CFO, Mr. Andy Yeung. We are dialling in from different locations today. If we experience any technical difficulties during the call, please remain on the line as we reconnect.

Before we get started, I'd like to remind you that our earnings call and investor materials 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 statements in our earnings release and the risk factors included in our filings with the SEC.

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

Today's call includes 3 sections. Joey will provide an update regarding our performance in the third quarter. Andy will then cover the financial performance and outlook in greater detail. Finally, we'll open the call to questions. You can find the webcast of this call and the PowerPoint presentation, which contains operational and financial information for the quarter, on our IR website. Also on the site, you can find a video we prepared that showcases our latest stores, offers and activities.

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

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

Thank you, Michelle. Hello, everyone, and thank you for joining us today. We achieved outstanding performance in the third quarter with fantastic growth, both top line and bottom line. This demonstrates our ability to operate in an uncertain environment by learning, adapting and strengthening business fundamentals. During tougher times, our resilient business model and agility helped us manage the negative impacts.

As COVID conditions were relatively calmer in July and August, we captured sales opportunities during the peak summer season. System sales recovered with 5% year-over-year growth. Operating profit surged 77% year-over-year to $316 million, even higher than 2019 level. Great teamwork made this possible. Key elements in our winning formula include our in-house and tailor-made supply chain, industry-leading digital and delivery capabilities, cost restructuring and solid execution.

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Let's move to KFC and Pizza Hut. We have been innovating new products to satisfy customer cravings. In the past 2 years, we have established strong presence in new categories such as beef burger, whole chicken and durian pizza. This was enabled by our powerful supply chain, by securing supply at scale, streamlining production and optimizing costs.

Let me share our success stories. At KFC, our extra juicy beef burgers rapidly captured meaningful market share. Since adding them to the permanent menu in May 2021, we have sold over 100 million burgers. That's about 5 beef burgers every second. For the full year, we expect to generate close to CNY 2 billion in sales from beef burgers. We cater to Chinese tastes by making the patty super juicy using our specialty ovens. Customers love our burgers for their great taste and value for money. We source our Wagyu beef, (Long jiang he niu), locally from Northeastern China and have signed a multi year contract to secure price and supply.

Our juicy whole chicken has also quickly gained popularity since its launch late last year. Year-to-date, we have sold over 18 million whole chickens. Whole chicken is a versatile product, good for both dine-in and take-home consumption. We use a different breed of smaller chicken with better cost that is the perfect size for an individual meal and particularly juicy. And it's good for sharing on the dining table at home as well.

At Pizza Hut, durian pizza has become a customer favorite. In fact, during Q3 promotion, every 4th pizza we sold was a durian pizza. Our limited-time durian trio pizza, (Liu lian san jing ling), with 3 types of durian was especially popular with durian lovers. Customers are increasingly value-conscious, yet we do not compromise on quality.

Last quarter, we shared about KFC's widely popular Crazy Thursday campaign, (Feng kuang xing qi si). Since 2018, we have been offering delicious food, including the latest innovations at amazing value. The campaign continues to be a phenomenal event, generating a significant boost in sales every Thursday. Our customers create witty and playful social media content using the Crazy Thursday theme. Many of these postings have gone viral, creating huge hype for us.

Now to drive weekend traffic for families and kids, we have introduced a Sunday Buy More Save More, (Zhou ri feng kuang pin), campaign in July. Customers can get a bigger discount when they buy more, up to 50% off for 8 items. This new promotion platform has built wonderful momentum with good value perception while protecting our ticket average.

Apart from abundant value, we also launched a golden SPA chicken breast burger, (Huang jin SPA ji pai bao). This is our first successful chicken breast burger. We added an extra step in the preparation process to make the breast meat super juicy and tender. This entry-price burger widens our choices for customers and is a great product for lower-tier cities.

We strive to keep our brands appealing to youthful customers. In September, we transformed select Pizza Hut stores into social hubs for gamers, partnering with the popular RPG game, Genshin Impact, (Yuan shen). We decorated stores, outfitted restaurant crews and offered exclusive gifts. The campaign generated extraordinary social buzz. In just 3 minutes, we sold over 300,000 themed combo meals. And our Super APP recorded its highest activity ever. I'm looking forward to more successful events with this partnership.

Let's move to digital and delivery. We have been enhancing our delivery and digital ecosystem to make our business fundamentally stronger. Customers love convenience. Delivery sales are growing fast. Empowered by our dedicated delivery riders and leading digital capabilities, delivery grew 19% year-over-year and reached 38% of sales mix in quarter 3.

Together with takeaway, off-premise sales were over 60%. Our ability to capture off-premise demand not only enables us to effectively serve customers but also cushions store closure impact due to COVID conditions. This 60% off-premise sales is so fundamental to our business model because it really protects our downside in both sales and profit despite the fluid situation.

We have been maximizing delivery coverage and flexibility using AI technology. Most recently, we launched Smart Delivery, (Tan xing shang quan), to dynamically adjust delivery coverage for each store by daypart, taking into account the operating hours of nearby stores. The upgraded system helps us serve more customers more efficiently.

Our digital capabilities serve as key touch points with customers. In quarter 3, we reached 2 milestones in our digital ecosystem: one, our

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loyalty programs reached 400 million members; and two, cumulatively, since 2018, KFC sold over 100 million privilege subscriptions. Our privilege subscriptions offer great value for money, and have been an effective tool, in driving frequency and spending.

Our digital capabilities are also crucial to streamlining restaurant efficiency. Digital orders optimize in-store labor efficiency and accounted for more than 90% of sales in the quarter. Pizza Hut's table-side mobile ordering sales have grown exponentially from just 2% at its launch in 2018 to 45% in quarter 3 2022. This helps mitigate rising wage inflation and frees up crew members to enhance customer service.

To improve digital experience, we introduced intelligent order sequencing at KFC, (Zhi neng ding dan jiao fu), in the third quarter. This system automatically arranges orders to shorten customer wait time.

Now let's move on to coffee, our third growth engine. Lavazza is making solid progress along its clear 4-pillar strategy. The pillars include brand building, menu upgrades, expanded digital and delivery capabilities and store development. Here's how we build these out.

Branding. Lavazza has a century-long reputation for coffee expertise. We will continue to accentuate its brand positioning as the leading Italian coffee brand, offering an authentic Italian experience.

Menu upgrade. We are broadening food and drink offerings with more unique Italian products, including KAFA premium single-origin beans and Tigelle, which is an Italian flatbread with meat or egg stuffing, something like our Chinese (Rou jia mo). We also launched localized products such as coconut latte, buffalo milk latte, and even osmanthus latte. Osmanthus, (Gui hua), is a very lovely, fragrant flower used in many Chinese desserts. These new products capture the latest coffee trend and have been well received by our customers.

Digital and delivery. We are building our membership program and digital fundamentals to improve customer experience and attract online traffic. Delivery reached almost 40% of sales mix in quarter 3.

Store development. Now with 78 stores, we have further refined our store models, paving the way for growth.

We have made great progress so far, but work remains. Good things do take time. We want to grow this brand right, with every step at the right time. In close partnership with Lavazza Group, we are confident to build a successful Lavazza business in China.

We decided to wind down our COFFii & Joy operation. From branding to site selection to operations and more, we learned a lot with COFFii & Joy. This invaluable learning experience will help us capture growing opportunities in the coffee market.

Going forward, we will grow our coffee business with 2 distinct market positioning: K-COFFEE, focused on value and convenience; and Lavazza, focused on authentic Italian coffee.

To summarize, our innovations and hard work in the pandemic years have made our business fundamentally stronger. We are confident in our team's ability to find opportunities in adversity and unlock further potential in China. We will continue to execute our RGM, which stands for resiliency, growth and moat, framework to strengthen our competitive position and capture long-term growth.

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

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

Thank you, Joey, and hello, everyone. Let me now go through the third quarter performance in detail. We saw sequential improvement in the third quarter. System sales returned to growth year-over-year and restaurant margin was the highest since 2018, well above our expectations. We focused on driving sales through new products and compelling value. Same-store sales recovered to the same level a year ago. From a timing perspective, the trend remains volatile impacted by frequent COVID outbreaks.

In July and August, we saw a sequential recovery in same-store sales, and August exceeding the prior year. This was mainly due to

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lapping the Delta variant outbreak in August 2021, which heavily impacted Eastern China. However, in September, same-store sales declined mid-single digits as COVID-related health measures tightened in many areas. Around 900 stores were temporarily closed or provided limited services in September compared to around 400 stores on average in July and August. On the margin side, we continued to identify cost-saving opportunities, drive labor productivity and rebase our cost structure.

Let me go through the financials and our cost control initiatives. Unless noted otherwise, all percentage changes are before the effect of foreign exchange. Foreign exchange had a negative impact of approximately 6% in the quarter. Third quarter total revenues increased 5% year-over-year in reported currency to $2.68 billion due to the contribution of new units and the consolidation of Hangzhou KFC. This was partially offset by temporary store closures and foreign exchange translation. In constant currency, total revenue grew 11%. System sales grew 5%. Same-store sales were flat year-over-year.

By brand, KFC same-store sales were flat with same-store traffic at 93% of prior year's level. Ticket average grew 8% due to the increase in delivery mix, which has a higher ticket average than dine-in. Abundant value campaigns, like the Family Bucket and Buy More Save More, also strongly contributed to higher ticket.

Pizza Hut same-store sales grew 2% year-over-year. Same-store traffic grew by 2%, while ticket average was flat. Higher delivery mix, which has a lower ticket average than dine-in was offset by discount management.

Restaurant margin was 18.8%, 660 basis points higher than last year. The year-over-year increase was mainly due to higher productivity, temporary relief and sales leveraging. These were partially offset by inflation in commodity, wage and utility costs. Rider cost also increased due to higher delivery volume.

Our team worked diligently to improve our cost structure, so let me next go through each expense line item and the actions we have taken. Cost of sales was 30.7%, 150 basis points lower than last year. We focused on the most effective campaigns to drive traffic. That allowed us to be more cost efficient while ensuring great value for money. We also managed commodity price inflation to low single digits.

Cost of labor was 23.5%, 210 basis points lower than last year. This was mainly due to improvement in labor productivity and relief recognized in the third quarter of $17 million. These were partially offset by increasing rider costs from higher delivery sales mix and wage inflation of 2%. We improved labor productivity by, one, optimizing staff scheduling and hiring; two, sharing restaurant management teams across stores; and three, leveraging digital tools to automate processes, such as digital ordering and inventory management. There was also a lapping impact due to higher staffing levels in 2021 caused by the sudden Delta variant outbreak.

Occupancy and others was 27%, 300 basis points lower than last year. This was mainly due to our cost-saving initiatives and lower rental expense as a percentage of sales. In addition, we pulled back on marketing and advertising.

Rental expenses were lower in the quarter due to, one, rental relief of $13 million; two, smaller store format with lower upfront investment and better store economics; and three, negotiating more rental relief with variable components.

G&A expenses increased 16% year-over-year, mainly due to increased compensation and benefit expenses, consolidation of Hangzhou KFC and incremental expenses from emerging brands. There were also onetime expenses associated with primary listing conversions in Hong Kong.

Operating profit was $316 million, a 77% increase year-over-year. The net contribution from Hangzhou KFC consolidation was 6% of total operating profit in the quarter. It includes amortization of intangible assets acquired, which was roughly $16 million per quarter. This will run through the end of this year.

Below the operating line, we incurred a [$12 million](corrected by company after the call) mark-to-market net loss on our equity investment in Meituan in the quarter. It was lower than the $32 million net loss in the same period last year. The effective tax rate was 29.9%, 160 basis points higher than last year due to Hangzhou KFC consolidation. Prior to consolidation, the equity income from JVs was

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not subject to tax, resulting in a lower tax rate. We expect the full year effective tax rate to come in around low 30s.

Net income was $206 million, a 72% increase year-over-year. Diluted EPS was $0.49, more than double the prior year period. The mark-to-market loss in Meituan negatively impacted diluted EPS by $0.03.

We have returned around $560 million to shareholders in cash dividends and share repurchases year-to-date. We temporarily slowed repurchases in the third quarter prior to the dual primary conversion. Helped by our strong balance sheet, we will continue to execute our disciplined and balanced capital allocation strategy. Our operating cash flow remains strong. In the third quarter, we generated free cash flow of $558 million.

Let us take a look at the fourth quarter outlook. The external environment remains challenging. COVID-related preventive health measures escalated in October. In October, around 1,400 of our stores on average were temporarily closed or offered limited services. Downward pressures on the economy, cautious consumer spending and inflationary environment are also headwinds that we continue to face.

Our same-store sales in the third quarter were below the pre-pandemic level. We expect a full recovery of same-store sales will take time and the path to remain uneven and nonlinear. I would also like to remind everyone that, one, fourth quarter is seasonally a lower quarter in terms of sales and profit. So sales volatility could have a more pronounced impact on profitability. Two, there was around $30 million temporary relief in the third quarter, most of which is unlikely to repeat in the fourth quarter. Three, the appreciation of U.S. dollar against the yuan may negatively affect our reported numbers. And four, we continue to dial back some austerity measures to balance cost reduction and service level.

Now despite the headwinds, in the third quarter, we resumed the pace of store openings and opened 621 net new stores year-to-date. By relentlessly optimizing store economics with lower upfront investment, our new store performance continued to be strong. Store payback remained healthy at 2 years for KFC and 3 years for Pizza Hut. This gives us strong confidence for further expansion. We will continue to implement our disciplined and systematic store opening approach, opening new and profitable stores at a robust pace. As the fourth quarter is usually the peak season for store openings, we are confident in reaching the full year target of 1,000 to 1,200 net new stores.

Lastly, let me touch on our primary listing conversion in Hong Kong. It became effective on October 24 along with our inclusion in Southbound Stock Connect. We expect the new status will provide additional access to investors, broaden our shareholder base and increase liquidity.

So to round up, we have learned to navigate through uncertainties and volatilities in the past 2 years. COVID conditions will continue to remain challenging, but we're adapting to the new normal. Our resilient business model and agility allow us to pivot quickly and effectively develop new strengths. When the market is relatively calmer, we are able to capture the upsides and deliver strong results.

In the third quarter, we have once again demonstrated our transformed fundamentals, cost control and solid execution. We are confident in our ability to achieve long-term growth in China and generate sustainable returns to shareholders.

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

Michelle Shen ***Yum China Holdings, Inc. - IR Director***

Thank you, Andy. We'll now open the call for questions. (Operator Instructions) Ashley, please start the Q&A.

QUESTIONS AND ANSWERS

Operator

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

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

Congratulations on the very strong Q3 results. Given the very fluid situation amid the COVID outbreak and restrictions in China, my question will focus on margins. We have seen very impressive margin expansion in Q3 results. And over the past 3 years, we also observed a pattern that usually, during the first few quarters of a big COVID outbreak, such as the Wuhan one or the Delta outbreak in Q3 last year and the Omicron outbreak early this year, we might see a few quarters of margin erosion.

But our very agile and quick adaptation in the following quarters, we actually -- we managed to achieve margins that could be even higher than the pre-pandemic level. And let's assume that next year, we are not going to see another big wave of outbreak that would lead to massive lockdowns in our core markets such as Eastern China, is it fair to say that we can actually achieve a restaurant margin that is largely comparable to the pre-pandemic level, which is around mid-teens? So this is my question.

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

Chen, thank you for your questions. Obviously, our team has done a fantastic job to deliver solid margins amidst a very difficult and challenging situation. Now our margin improvement, obviously, some of these fundamental transformation, that would last going forward. Some of this is more temporary and some of these austerity measures we may dial back as things return to normal.

Now if you look at our margin improvement, it was largely contributed by high productivity, right, and also for the quarter, some temporary relief and sales leveraging. Now so when we look at the initiatives that we have undertaken over the past couple of years, we have mentioned, over the past few quarters, we have taken initiatives to rebase our cost structure and also to drive efficiency gain. So you see a lot of new product innovation in terms of our COS, how we manage the pricing and also the cost inflation and commodity prices.

Our supply chain team continue to be our core strength in terms of managing supply and robustness of our supply chain. And also sort of mitigate partially some of those impacts from high commodity prices and allow us to continue to innovate and quickly to roll out new products that meet the consumer demand.

The other one is, obviously, you look at the labor productivity. For example, we have deployed technologies. We continue to invest in technologies to automate our system processes, to help improve labor productivity. As we have mentioned probably last quarter, we're beginning to roll out a management tool for our stores. So our management team for the store can be used across multiple stores.

And if you look at our rental, for example, obviously, we see some rental relief, but we also have, over the past few years, and especially over the past couple of years, to work very hard to restructure the rental cost structure with the landlord, not only seeing lower rental cost but also more variable and flexible rent structure. And so those are fundamental transformations will continue going forward.

Same thing for our digital investment. Over the past few years, we have continued to invest heavily in digital that allow us to, for example, during the pandemic, have direct outreach to our consumer, roll out new products, new marketing campaigns efficiently and also allow us to -- if you look at our membership program, which continue to be a very strong foundation for ourselves, the membership program now accounts for almost of 60% of our sales. So those will continue to help us going forward to maintain efficiencies and operating efficiency.

However, as we mentioned before, some of this is temporary. For example, the rental relief, some of the relief in our labor costs, especially some of the government incentives or relief as well as the delay in wage increase in the market in the third quarter, usually, we adjust wages in the third quarter for our market, labor force, but because of the pandemic impact this year, many markets have delayed wage increase. So some of this may come back and also some of that austerity program.

So all in all, I think -- looking forward, I think you can expect some of these fundamental changes would stay and some of these temporary measures may subside over time.

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

I would like to just add some color in terms of our management team's thinking and also the business model, why that helps protect the margin now and in the future. Well, we do believe that this company and this team, this management team, is an anti-fragile company. Whatever stone is thrown at us, we possibly could convert these stones into our stepping stones to go further and higher. That's what we believe and then our team keeps trying to do the right thing.

In terms of business model, as I mentioned in our -- in my presentation earlier, it's very important to recognize that our off-premise business right now is 60%. What does that mean? Well, if we look at it by brand, KFC is actually 65% off-premise. And that is up from last year, which was 60%. Now Pizza Hut tells an even more amazing story. Pizza Hut, the off-premise sales is 50%. Before pandemic, it was only 30%, from 30% to 50%. So our business, our off-premise business in Pizza Hut is much, much stronger and higher.

Given the fluid situation in the pandemic, these are incredibly important numbers because when we are in sort of a more tougher situation, in times of lockdowns, that 60% will become higher because there will be naturally some sales transfer from dine-in to additional off-premise business. So with the 60% sales in off-premise, in fluid situations, that percent will go higher. That naturally protects our business, ourselves, because it's very difficult to have a strong margin when the sales leverage is not there. So it's not only all the margin line that we prepare, as Andy has comprehensively pointed out, but on the other side, the sales side that we have also protect. And that's a lot of hard work in the last 3 years, and the team has done a great job.

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

Joey and Andy, your margin management capability is really impressive. Congratulations again.

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

Thank you.

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

Thank you.

Operator

Your next question comes from Lillian Lou with Morgan Stanley.

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

My question is also a follow-up question on margin management but maybe from a different angle because, Joey and Andy, you mentioned about the sales leverage and also the line items, management on cost side. So maybe look at it, all the initiatives in the third quarter and also during the pandemic in these 3 years, you've been focusing on really kind of rejuvenizing the menu and the new product launch and smaller stores, a very effective promotional campaign. So when you are designing this, what's your thinking behind?

Especially trying to understand that with our new stores now incrementally a higher portion of small stores, would that actually fundamentally change our margin profile going forward? And also, especially third quarter, you have more promotional campaign, but in return, actually, it didn't suffer on margin instead it's on the opposite side, you improved the margin. So I'm trying to understand a little bit further how you achieve that from these efforts.

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

Thank you, Lillian. I think in terms of margins, I think I want to emphasize at least in the short term. Because of the COVID situations, we see fluctuations in our sales. It got impacted and high correlation with the COVID situation. So the biggest lever of deleveraging impact when things come down is actually sales, right? Higher store sales generally will drive higher restaurant margin. And we can see that, even without the pandemic, in a normal time, we'll see that margin fluctuate through the year during the first quarter, and the third quarter generally is higher sales period for us and we also see higher margins. And then in second quarter and especially the fourth quarter, generally a lower sales season for us and you'll also see lower margins. So I want to emphasize and echo what Joey had mentioned earlier, sales is very important to us in terms of driving margins and also leverage.

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Now in terms of our store format, our store format remains very, very healthy unit economics, probably better in the recent years. This did not just come naturally, but a lot of hard work we have put into the store format design, operations and then also the menu mix, et cetera, to make it work. Now our store format, obviously, right now are geared to our 2 areas, largely. One is on the greenfield, right? So we still have a lot of cities and townships that we can serve. And then we have a format for that. We also have formats for catering towards the urban area where we're increasing density and cater to the higher mix of delivery and takeaway business. And so -- but they all have one thing in common, is that our store format in terms of upfront investment are generally lower.

So compared to a few years ago, we're spending, on average, RMB 2.5 million per store. Now we are spending less than RMB 2 million, close to like maybe driving down to like RMB 1.6 million, RMB 1.7 million per store. So that helped us sort of like be more agile, more nimble and reduce upfront investment. That allowed us to continue to see very strong unit economics for the new stores that we open.

Now as I mentioned on our prepared remarks, if you look at our payback period for KFC, it's still very healthy at 2 years. Obviously, there may be some fluctuations depending on the pandemic. And for Pizza Hut, it's 3 years. If you look at the satellite store model, as we mentioned before, its performance is very close to what we can achieve with KFC already. And so that's what gives us confidence in terms of robust store expansion. And I don't think we're too concerned about, at least from the store economics, that, that would have a material impact on our margin mix going forward. So that's the store format and then also our store economics for new stores.

Joey, do you have anything to add to it?

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

Yes. Let me -- again, let me add some color in terms of the relation between promotion and margin management. As we mentioned earlier, we consolidate our promotion mechanism, and we focus on fewer and more impactful, such as (Zhou ri feng kuang pin), Buy More Save More. They help drive our sales during weekends, which is quite effective. But at the same time, we are very, very careful to manage our products.

For example, the whole chicken, right? The whole chicken -- I'll give you one example, you guys will get it. Sometimes it's more detail to get it. We sold 80 million whole chicken so far this year. It's roast chicken. Why not fried chicken? Well, here is the reason why. Oil this year is very expensive. So if we do roast chicken, it has 2 benefits. One, it's healthier, two, it costs less. Customers love it. So we go through every little detail, make sure that it has both great products but at good cost. And that works for not only dine-in but at-home consumption. So just a small example to give you a sense.

And in terms of margin protection, I would like to share another belief which result in very good results. Back to Q2, it was a very difficult quarter. We reiterated our commitment to protect our staff's jobs, no layoffs. We looked at every single way to manage our cost structure, our margin, except layoffs. We want to protect our employees' jobs during the tough time. Everyone needs some sense of security during very fluid situations. And our staff, our 400,000-strong team, they appreciate it. And everyone, everyone go for every single innovation that we can achieve to protect our company.

I'll pause here. Let's move on to next question.

Operator

Your next question comes from Xiaopo Wei with Citi.

Xiaopo Wei ***Citigroup Inc. Exchange Research - Research Analyst***

Joey, Andy, I will also ask a question about the margin, but I will take another approach, maybe the bigger picture of what happened in the past 2 years. If we look at what happened in the past 2 years since COVID, we are seeing you open more stores. But in the third quarter, it's the first time that we are seeing amazing restaurant margin with some very short window of rebound about all the consumption, et cetera. But I can see that you greatly captured that upside of the consumption rebound. Should we say that actually the new store openings, which was the investment for the future, started working well in that situation. Looking forward, when the COVID is phasing out, actually, are new store contribution to profitability would actually be more pronounced than before?

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Another question related to this is, if we look at the delivery sales contribution, KFC hit 37%, which is amazing, very close to Pizza Hut. I do remember years ago, when I first met Joey, I had the impression that KFC had never been that high in terms of delivery sales contribution for Pizza Hut. And now we are seeing Pizza Hut and KFC having a very close kind of delivery sales contribution. Shall we say that looking forward, KFC fundamentally has transformed and we are expecting actually higher-than-expected delivery sales contribution looking forward, approaching 40%?

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

So I think there's a lot of question about margin today. Obviously, we're very pleased with our margin performance in the third quarter. As we mentioned, the sales leveraging, when come a time, we will not only able to capture not only the sales upside but also able to regain the sales leveraging. So obviously, as I mentioned before, there's a number of fundamental transformations that we have undergone, rebasing our cost structure, [digital](added by company after the call) initiative. But I think what you are asking about is about 2 things, right? One is the new store margins and profitability. The other one is the delivery sales mix, what's the percentage going forward.

Now I think when we look at the new store economics, I think -- one thing to remember is that for any new store, it generally takes a couple of years for it to ramp up sales and margins to maturity level. The other part is that, obviously, we're very pleased. As you mentioned, when we look at our new store performance, they continue to be very robust, very strong. If we look at the margin front, I mentioned the ramp-up period. But even for the store that we opened this year, a large majority of them turned to restaurant breakeven or better within 3 months of time, which is tracking on par or slightly better than the historical level.

And so I mean, there's a couple of things that is happening there, right? One is, as we mentioned, we have worked very hard to find the right format, not just reducing the size, the size is obviously important, but also the operations, the total offering and the menu mix. So all these worked in conjunction with that. We also -- as we mentioned, we have worked hard on changing like the restaurant management structure. We have developed a management labor pool they can share with the store to make productivity improvements. So I think -- and then also, if you look at -- in terms of rental, for a new store, obviously, we have worked very hard to lower the rental cost as percentage of sales. But more importantly, to keep us resilient, we continue to work with landlords to develop a high proportion of variable cost component. And so that allowed us to be more resilient over time.

So I think our approach to new store opening is very disciplined and systematic, as I mentioned before, and we'll continue to drive that discipline so that when we open new stores, as we continue to at a very robust pace and likely accelerate during the fourth quarter, we will continue to open not only new store but profitable store. And so I think the portfolio contribution for new stores is important over time. But I think the economies of scale, I think, is on par, as we mentioned, payback period is 2 years for KFC, 3 years for Pizza Hut, which is pretty consistent. So that's for new store margin and profitability.

In terms of delivery sales mix, obviously, in the short term, we've going to be depending on the COVID situation, the tighter measures. We've going to see a higher delivery mix shift. And then sometimes, we see that things are calmer and then dine-in traffic would come back. But all in all, I think we can see there's a big change in our business. Delivery mix right now and off-premise right now account for a majority of our sales now. And so that's why like when we're developing store format, as we mentioned before, for the smaller urban format, we do those more catering like delivery and takeaway business. So high growth, I think it will depend on the consumer. If they want more, then we'll deliver more. And we have the format and system to help achieve that, especially on the digital side. Like we have our own app to drive traffic and work with aggregators. So the consumer can order delivery whenever they want, and we have a store to serve them.

Operator

Your next question comes from Michelle Cheng with Goldman Sachs.

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

My question is about store expansion. So given this very strong profit margin, do you have any initial thoughts on the expansion plan into 2023? Any chance we could further accelerate expansion given we know all the smaller players are suffering. And also more specifically by brands, so aside from KFC, Pizza Hut maintaining a relatively stronger momentum on expansion, how do we think about other brands since we're actually reshuffling other brands quite aggressively in the past few quarters.

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

Michelle, about new store and as I mentioned, our new store performance continues to be strong. And also, as I mentioned before, I mean each year, we set a target we think what is reasonable, but ultimately, it is for the market and the fundamentals that we would drive how many stores that will be opened and then also sometimes get impacted by COVID. So we will continue to maintain that disciplined and systematic approach. So when you see the economics are good, the system we're building, you'll see that acceleration because stores we propose and more stores we approve.

Obviously, when the market or like the unit economics are more moderately impacted, then we see some deceleration automatically, because it's due to the model and the assumption itself, will refresh that very regularly. So we will maintain that very disciplined approach. Obviously, we'll continue to see very strong fundamentals for store opening. We see, as I mentioned before, the greenfield. We have more KFC, we're only open in a little bit more than 1,700 cities. We see probably another thousand that potentially we can enter. Pizza Hut, like almost 1,000 stores that KFC already in, we don't have a Pizza Hut store. So there's a greenfield opportunity. So we feel very good about store expansion, store network expansion and opportunity there.

Now in terms of -- obviously, we'll continue to have to work hard on the store format, right, because the consumer demand could change -- and we see obviously opportunities right now. Our pipeline is very strong because we are one of a few very attractive tenants right now in the restaurant industry. After 2, 3 years of pandemic, we continue to perform very well, pay our rent on time and everything. So we move them attractively even more attractive tenant, so we have more opportunity. But our emphasis, again, is on discipline and systematic approach to make sure that we not only open a new store, but open new and profitable stores. And so that's important.

Now as you mentioned, we did some portfolio management on our brand. As Joey mentioned earlier, we are winding down C&J to focus our resources on the coffee side, on Lavazza, which we see very good opportunities, a lot of potential there. And so that's a disciplined approach. We also -- earlier part of this year, we also wind down the East Dawning business. And East Dawning have been a homegrown brand for close to a decade now. Unfortunately, its market positioning is in transportation and tourist locations. Now that business has been very, very challenging over the past 3 years, as you can imagine. And currently, we don't see with the new normal improvement in any short time. So we decided to wind that business down. So again, back to that discipline and systematic approach, be it in store level expansion, be it in portfolio management, we are very disciplined about that. And so we will continue that going forward about the brand development.

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

Michelle, I'll just add a few comments about the store expansion. First, we certainly are opening even more smaller stores. So for Pizza Hut alone, over 50% of the new store opened this year are either smaller or satellite store, and KFC is about half. And these small stores work particularly well in lower-tier cities, and that's where we will continue our store expansion. And the result is pretty exciting and promising. So that's comment number one. Comment number two is opening new -- the smaller stores also require focus on the product and operations side, and we are giving that support to the new smaller stores. For example, chicken breast burger, (Jixiongrou bao). The price is very good. It's RMB 9.9. It's brilliant. It's amazing for the lower-tier city new stores as introduction to our business.

The other products like (Yansuji), we developed these products with lower price points, specifically for lower-tier cities and specifically for the introduction of new store. And at the same time, we also continue to innovate in terms of operating process within the small stores. Well, one example, smaller stores we only can accommodate fewer number of staff, which is a great news for shareholders. But that also requires changes in terms of operating process, how to still make it work to protect our product quality, food safety. You name it. So not only just the costs of opening new stores, but also the product and the operating process that we are focusing on.

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Operator

Your next question comes from Anne Ling with Jefferies.

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

Regarding the cost side, we look at like -- we track the chicken price and which we saw a 20-odd percent increase. And also, at the same time, flour costs also increased. I understand that management has a really great way in terms of like making use of all chicken parts. But moving into like year 2023, when do you see this increase in terms of the cost, the chicken costs or the other commodity costs kicking into your P&L? Or maybe you can share with us what is your current agreement with your supplier.

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

Joey. Do you want to?

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

No, no, go on.

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

So when we look at our COS obviously, I think we do have to comment on how fantastic job our supply chain, our product innovation team have done to help us manage that cost inflation. Commodity price inflation, as you mentioned, is very real and is real globally and it's true also in China as well. Obvious in China, we see more moderate inflationary pressure. But still, we see the commodity price increase escalating over the past probably like a year. We see a very favorable pricing last year, 2021. We're beginning to see that commodity pricing pressure building up. And right now in China is probably, mid-to-high single digits food commodity pricing increase. And as you mentioned, we all see poultry price increase -- so as I mentioned before, this will continue to be happening. And we'll continue to work hard to sort of mitigate it.

The other one I want to mention is that as we have mentioned before, our supply chain generally locked down most of the supply, a quarter or 2 ahead of time. So there will be some lagging impact on the inflationary side. And obviously, because we are in an inflationary environment, our supply chain also deploy long-term contracts to try to when it is possible, to lock in pricing a little bit longer. For example, coffee, they have done a fantastic job at locking a longer-term pricing contract. But some of the commodity you cannot lock in for such a longer time. So we'll see some commodity pricing pressure building up in the coming quarter as well.

Now as you mentioned to deal with commodity pricing pressure besides of the supply chain and the efficiency there is also on product innovation, as Joey has mentioned. The team has done a fantastic job developing new products, that utilize even part of the resources that we already have, chicken, beef. For our folks in the U.S., like when people talk about chicken sandwich or chicken burger, generally that will refer to chicken breast. But as we have mentioned before for Chinese consumers, generally, they like dark meat more than white meat because dark meat tends to be more tender and more flavorful.

So this, for example, this quarter, as Joey mentioned, we have developed a fantastic chicken sandwich, chicken burger that is very successful, very well received by the consumer. Now like that kind of product innovation will satisfy consumer demand and also help us to manage commodity prices, will be very key for long-term managing that COS. So yes, so that is commodity pricing inflation. And then also, obviously, how do we manage our marketing campaign, how do we manage other costs, wastage and all that will be also important for us in the long term to manage the COS.

Now for labor inflation, as we mentioned before, generally, bad time, good time, we will likely see labor cost increase. Sometimes it will delay, sometimes it's more moderate. But in China, the long-term trend is mid- to high single digits. And so in long term, we will continue to have to work hard to improve their productivity, invest in technology, IT, invest in infrastructure, and as Joey mentioned, continue to innovate, continue to improve our store operations, so that we can maintain labor efficiency that will be gained to offset that labor inflation. And so that sort of like commodity price and labor inflation.

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

Anne, I'll just add one comment on that one. We do use every part of chicken except for the chicken feather. But I would also like to point out that we have our team, both the pricing team and then the product innovation team, we have been able to introduce and use different proteins; beef, pork, fish and duck. We are selling duck burger right now as we speak right now, chicken and duck burger. So we have a variety of proteins in our pipeline that we can use and we can promote, depending also on the price.

I mean, the thinking is rather simple, a good chef, they look at what is the best in terms of quality, not only price, quality and price available in the market. And then you turn these fantastic ingredient into great food. Same for us, just at much, much bigger scale, I guess. So we have both the flexibility and the scale to deliver amazing food to our customers at very good price and very good value. Thank you, Anne.

Operator

Your next question comes from Christine Peng with UBS.

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

So my question is on the product side. So I spotted a very interesting new product, which Joey mentioned, which is the beef burger. So I noticed that this product has been on the menu since May of 2021, which means that this is likely to be a long-standing product instead of LTO. So if that is the case, Joey, can you share with us the distinction behind this product in terms of the rationale, the supply chain management and also future plan for this product going forward. Because what I'm interested to understand is that will this be a burger potentially become a very important category for KFC going forward? And what's going to be the structural impact on KFC in terms of competition, in terms of margin trends, et cetera. So anything you can share with us, that will be very much appreciated.

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

Thank you, Christine. Well, it's already a very important product in KFC portfolio. The speed and the support from the customer exceeds our expectation. To quantify the sales of beef burger, I mean we talk about it already. It already contributes a meaningful sales mix to our business. It's about 3% to 4% of KFC sales mix, but that is a lot already because for original recipe after all these years, it's about 6%, 7%. So it's half of our original recipe chicken sales already. So that's the number side.

In terms of product side, for those who are in China, if you have a chance to try, I do strongly encourage you to try it, then you can form the opinion yourself about the future of this product. I know it's rather unusual for a company selling chicken to sell beef burger, but once you try it, you will understand why. We have good range of product choice there from entry price burger, which tastes amazing still, beef burger all the way to Wagyu beef burger, Angus beef burger. And as Andy mentioned, it's hard to imagine, but it tastes amazing. Wagyu beef, you can't go wrong on a Wagyu beef burger. So -- and the price is still very good value. I won't say it's low price. I mean, Wagyu beef burger is fantastic value. So the choice of product is fantastic.

Third is the flavor, the taste. There are plenty of customer -- customer made video comparing our burger versus other competitors. One thing very distinct about our beef burger is the burger, it's very juicy, and this is our focus. Because while some traditional beef burger lover might love the barbecue flavor, for Chinese taste, they prefer the juicy burgers. And that has been our focus. And we are uniquely positioned to do that because we have very high quality ovens in our kitchen, each of our KFC kitchens to produce the beef burger. So the beef burger is a patty, it is cooked in an oven, not on grill. So I hope that gives you some flavor of this amazing product that I love myself.

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

Joey, let me add a little bit here because as I'm self-proclaimed #1 fan of KFC. I eat there very often, and like -- but still sometimes I do need variety beside chicken and rice -- so I think the beef burger is fantastic. The beef burger not only have 1 Wagyu beef burger, but now we have a range of burgers, a beef burger that can appeal to different pricing points. I myself increase my frequency to go into the store because when I want to eat beef, I have fantastic choice for the KFC beef burger. So from a customer standpoint, I think it's fantastic because it provides greater variety like you mentioned, different proteins, different choices. And so I love it. Anyway.

Operator

Your next question comes from Veronica Song with Credit Suisse.

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Veronica Song ***Crédit Suisse AG, Research Division - Research Analyst***

Congratulations on a very strong set of results. I have a question regarding the coffee business. So as Joey mentioned, we're going to wind down the COFFii & JOY business and focus more on the K-Coffee and Lavazza. So could you share more color on the current situation or achievement of Lavazza, especially in terms of store expansion and any color on store economics? So how can we adopt the valuable experience we learned from both COFFii & JOY and KFC to drive Lavazza's success?

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

Okay, so I think first of all, I think is I want to repeat it quickly, which is winding down the C&J business so that we can focus more of our resources, on the corporate resources on Lavazza and give, obviously, the team more focus, more laser focus on the market. And as you mentioned, currently, our coffee strategy have 2 key brands. One is K-coffee, which serves the value and convenience segments. And for Lavazza, we will be focusing on offering authentic wonderful Italian coffee and experience. So from obviously, C&J, with our homegrown brand over the past 4 years, we've learn a lot. And this is one thing that we have keep saying, we have healthy respect when we enter into a new business segment. Coffee business is very different, obviously from fried chicken and Pizza Hut business.

So there's lot of learning there in how to [do](corrected by company after the call) our product, coffee, water, milk, the whole process to make good coffee. Bean selection, obviously, is also very critical. And then obviously, for coffee too, the store format, it takes time to figure out what is the right format at different trade zones and economics and whatnot. And then also in terms of the Chinese customer, coffee is still a relatively new market segment. A lot of Chinese consumer are still very new to good coffee, the taste of coffee and what their preference are, also need time to spot for us to develop and learn and apply to our product development. So a lot of it is learning, I think, a wonderful learning that we did with C&J would help us to obviously apply to Lavazza as we roll out and expand its business.

And for Lavazza, we continue to recover from, obviously, from challenging time because a lot of store closed in Shanghai in early part of this year. And we see recently, a business has rebounded. I think in terms of the product, the team, they continue to be on the right track. I think we don't -- I don't think we can say like we're there yet, but building a new brand, a new business is going to take time, but they have done a great job in terms of putting the right -- organizing the right team, putting the -- continue to innovating the product. You've seen a lot of new product innovations, right, where the buffalo milk and latte and drinks -- we also see the coconut latte and all that have been wonderful success with the consumer. That sort of like offer that Italian experience, but also flavored that is geared to a Chinese consumer.

And then we'll continue to do more, I think, like in terms of drink and food innovation. Our store format is the same thing. You see that they continue to experiment and roll out. And overall, you see the unit economics improve but I think for them to reach obviously, their consumer awareness, the sales level and also the profitability, it takes some time and I think people have to be a little bit more patient on that. They have also opened quite a bit of stores this year, almost double. Right now, we have 78 stores and we continue to open more stores. And then we also continue to develop its capability. They continue to develop its digital and delivery capabilities.

So if you look at sales mix now, you can see that the membership program and also delivery program continue to increase. Delivery now almost like 40% of the sales mix now. So that's a great improvement, especially given the challenging environment with COVID.

In terms of store development, as I mentioned, like 3-fold improvement, increased from a year ago to 78 stores. There will be more and -- but you should not -- like COVID obviously will have some impact. I think last year, we mentioned 1,000 stores and we're very much committed to that. But obviously, the timing of that is going to be depending on some market conditions, especially with COVID. As we mentioned, we have a very systematic and disciplined approach even with the new coffee brand like Lavazza. But I think we're pretty confident as the store economics improve, you will see more store open. So that's the store update on Lavazza.

Operator

There are no further questions at this time. I will now hand back to Ms. Shen for closing remarks.

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Michelle Shen ***Yum China Holdings, Inc. - IR Director***

Thank you, Ashley. Thank you all for joining the call today. We look forward to speaking with you on the next earnings call. If you have further questions, please reach out through the contact information in our earnings release and on our website.

Have a great day.

Operator

That does conclude our conference for today. Thank you for participating. You may now disconnect.

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