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PRESENTATION

Operator

Thank you for standing by. And welcome to the Yum China Second Quarter 2023 Earnings Conference Call. (Operator Instructions).

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

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

Thank you, Ashley. Hello, everyone. Thank you for joining Yum China's second quarter 2023 earnings conference call. On today's call are our CEO, Ms. Joey Wat; and our CFO, Mr. Andy Yeung.

Before we get started, I'd like to remind you that our earnings call and investor materials contain forward-looking statements, which are subject to future events and uncertainties. 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. You can find a webcast of this call and a PowerPoint presentation on our IR website.

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

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

Hello, everyone, and thank you for joining us today. I'm delighted to report outstanding performance in the second quarter, both top line and bottom line. Our results are a testament to our resilient and anti-fragile business, which allows us to capture upside in good times and protect downside in bad times. From the back office to the front lines, our teams are doing a great job. During the quarter, we reached new heights on multiple fronts.

First, sales performance. Total revenue of $2.65 billion set a new record for second quarter, especially given the exchange rate. System sales grew 32% and same-store sales grew 15% year-over-year. We observed strong demand around holidays. Trading for the May 1 Labor Day holiday was vibrant. However, demand actually softened afterwards with a dip in customer traffic. We adjusted nimbly with attractive campaigns and regained sales momentum in June. On June 1, Children's Day, we hit a record 8.5 million transactions. That's equivalent to a transaction every minute in every location across our 13,000-plus store portfolio in a single day.

Thanks to our amazing operation team, robust end-to-end digitalization and agile supply chain, we flexibly handled the spike in demand during campaign without compromising quality and customer service. The results demonstrate our brand equity and ability to connect with customers with delicious, innovative food and compelling value for money.

Second, store expansion. In the first 6 months this year, we opened 655 net new stores, setting a new record. We continue to see vast opportunities across all regions and city tiers in China. KFC continued its aggressive expansion, hitting 9,500 stores in over 1,900 cities.

Notably, Shanghai became our first city to reach 500 KFC stores. Our 500th store is in the Shanghai Library, (Shanghai Tu Shu Guan). As part of our Book Kingdom Program for kids, it features a dedicated leading area to promote the love of reading to children. It's also one of our 36 Angel restaurants of KFC China. The restaurant offers a warm inclusive space for employees and customers with special needs. This showcases our commitment to positive social impact in the communities we serve.

Pizza Hut opened a record 169 net new stores in the first half of the year, supported by strengthened fundamentals through the revitalization program. Healthy new store payback gives us confidence for accelerated growth. In addition, Pizza Hut reached 3,000 stores in China, a milestone that few casual dining restaurant chains can claim. Our 3,000th store is in Qinhuangdao, a popular holiday destination in Northern China. This resort themed store boasts a beautiful patio with stunning sea view. In addition, it was built with eco-friendly materials and an intelligent energy management system.

Third is profitability. Our operating profit for the first half of 2023 has already exceeded the entire year of 2022. This achievement reflects our ability to capture sales and rebase our cost structure. Our rent ratio in the first half was below 9%. That is the best ratio in the past decade.

Now, let's talk about KFC. Our value platforms generated amazing sales results. First, Crazy Thursdays, the famous Crazy Thursday, (Feng Kuang Xing Qi Si) continue to be a tremendous draw, driving 50% more sales than other weekdays. Second, Sunday Buy-More-Save-More(Zhou Ri Feng Kuang Pin) energized Sunday sales. We captured at home consumption with our juicy Whole Chicken (Mi Zhi Quan Ji). We sold 22 million of this product in the first half and more than doubled its sales year-over-year. Third, our Weekday Value Combos (OK San Jian Tao) are gaining popularity. We added the new Sizzling Roasted Chicken Thigh Burger (Zi Zi Kao Ji Tui Bao) to enrich our entry price point offering for just USD 3. Customers love the new Weekday Value Combos.

Delicious and innovative food continues to delight our customers at KFC. In the second quarter, we introduced K-zza, a creative twist on pizza that utilized our existing ingredients. We used the wrap from our Dragon Twister to make the thin crust and Popcorn Chicken as the topping. This fun, innovative, limited time offer generated strong sales. We see great potential for more K-zza variations in the future.

K-Coffee sales grew 50% with 47 million cups sold in the second quarter. Our Iced Sparkling Americano with Zesty Lemon (Bao Zhi San Ning Qi Pao Mei Shi) is the perfect drink to beat the summer heat. We use our soda fountain machines to make this sparkling drink without additional investment in the store. It has become K-Coffee's best-ever limited time offering.

Now, let's talk about our marketing campaigns. Connecting with families and children is an important part of strengthening our brand affinity. Around Children's Day, we partnered with Sanrio and sold nearly 3 million meal sets with adorable toys such as Hello Kitty. This campaign contributed to our overwhelming success on Children's Day. Of course, these popular toys also work very well with adults.

Let's move to Pizza Hut. We continuously innovate to offer better products at great value. Our new menu launched in May has been a big success and strong sales driver. Over half of the menu items are either new or upgraded from a year ago. Pizza is our biggest category, accounting for over 1/3 of sales. We continue to fortify our Pizza Expert image by upgrading existing products and introducing new toppings. Apart from our signature Super Supreme, (Chao Ji Zhi Zun) and Durian pizzas, we introduced new pizzas like Bolognese Pizza with Beef (Yi Shi Rou Jiang Niu Rou Pi Sa). It has the familiar taste of Spaghetti Bolognese. It has become a customer favorite, especially among children. We use quite a bit of existing ingredients to simplify store operations and to keep the ingredients fresh as well.

In addition, many customers are trading up to stuffed crust pizza, (Juan Bian Pi Sa), which accounts for nearly 40% of pizza sales. Most recently, we launched pineapple and cream stuffed crust, (Nai Xiang Bo Luo Juan Bian), to complement our other stuffed crust choices of cheese and sausage. Pizza Hut has been sharpening its value proposition and customer engagement. Our value platform, Scream Wednesdays successfully drove sales and traffic growth. Every Wednesday, we offer different meal choices from pizza, steak, rice and pasta to appetizers at attractive price of USD 3 to USD 5.

There are choices for 1 person meals and for social gathering. We continued our collaboration with Genshin Impact for the second year. This campaign significantly boosted sales and attracted many young customers. We sold more than 2 million meal sets with themed accessories, tripling last year's numbers. This wildly popular campaign helped us recruit over 1 million new members.

Let's switch gears to Lavazza. Lavazza continues to make good strides forward. In July, we crossed the 100-store milestone. In addition to the coffee shop business, we sell Lavazza coffee beans and capsules to premium hotels, restaurants and other channels. Recently, Lavazza also started supplying coffee beans to Pizza Hut to upgrade the coffee at Pizza Hut. I'm happy with the progress we have made and excited about the growth opportunities.

Now on to digital. Our digital ecosystem plays a crucial role in recruiting and engaging members, driving the activities and unlocking sales performance and potential for us. Our loyalty programs now exceed 445 million members. Member sales increased to 66%, setting a new record. Our SuperApps had a major update earlier this year, offering our customers a better digital experience. We introduced interesting member exclusive perks to tickle our customers, such as App-exclusive new product pre-sales and lucky draws utilizing member points.

In addition, we have been working with third-party online platforms to expand our reach. For example, prepaid discount vouchers (Yu Fu Quan) have been gaining popularity on short video platforms. By offering geographically specific deals, we effectively attracted new members and increased spending of existing [members] (corrected by company after the call).

Our end-to-end digitization unleashed great potential of our Restaurant General Managers (RGM). Our store management team sharing initiative is progressing well at KFC and Pizza Hut. Selected RGMs for the first time in our history, can now manage multiple stores. Our AI-enabled systems have streamlined administrative work to help relieve our RGMs of repetitive tasks. By further integrating our store management systems, we enhanced the visibility of store operations and cross-store data analytics. These digital tools empower our RGMs to manage multiple stores more effectively, while upholding operating standards. This will be a driver for future store cost management and also address our bottleneck of new store openings. So, we are looking forward to more progress going forward.

As we speak, we have entered our summer peak trading season. We are ready to capture summer holiday traffic with eye-catching menu items backed up by rock solid operations. At KFC, we have brought back our crowd-pleasing fried chicken taco with a new ingredient - Bullfrog (Niu Wa Ta Ke). It does not translate well but trust us, it is a delicacy for our customers in China. At Pizza Hut, we have extended our popular Durian pizzas with a new product, Durian Coconut Lava Pizza, (Bao Jiang Liu Lan Sheng Ye Pi Sa). To handle increased demand in the summer peak season, we are ramping up crew resources, securing supplies and staying vigilant with multiple scenario planning.

With that, I'll turn the call over to Andy.

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

Thank you, Joey, and hello, everyone. Let me now share with you our second quarter performance. I'm delighted to report a robust performance in the second quarter. We achieved record revenues of $2.65 billion, representing 25% year-over-year growth. Operating profit of $257 million also reached a record level, more than tripling that of the prior year. We accelerated new store openings. We opened 542 new stores, resulting in net new store growth of 422, setting a new second quarter record.

Even though same-store sales remained below 2019 levels, we saw 25% growth in revenues and 26% growth in operating profit in the second quarter compared to the pre-pandemic levels in 2019. We accomplished all this while operating in a challenging and volatile environment. An uptick of COVID infections started in late April. Consumers continued to be value conscious. Sales materially weakened after the May 1 holiday. But by leveraging our multiple scenario planning, we swiftly responded by launching attractive offers to drive sales. Our sales subsequently improved in June.

To provide more context, in the second quarter last year, multiple cities were under lockdown. We are lapping last year's austerity measures and temporary relief. Now with that, let's go through the financials. Foreign exchange had a negative impact of approximately 6% in the quarter. Second quarter total revenues were $2.65 billion in reported currency, a 25% year-over-year increase. In constant currency, total revenue grew 32%. System sales increased 32% year-over-year in constant currency. The strong growth was mainly from same-store sales growth of 15%. The remaining growth can be roughly split equally between new unit contribution and the lapping of last year's temporary closures.

Dine in sales rebounded significantly year-over-year, while delivery continued to grow. By brand, KFC same-store sales grew 15% year-over-year. Same-store traffic grew 21% and ticket average decreased 5%. It was driven by successful traffic-driving promotions, the lapping of large community purchasing orders and the decrease in delivery mix. Delivery has a higher ticket average than dine in. Pizza Hut's same-store sales grew 13% year-over-year. Same-store traffic grew 27% and ticket average decreased 11%. It was driven by successful promotional activities and the lapping of community purchasing orders. Lower mix of delivery, which has a lower ticket average than dine in at Pizza Hut partially offset the ticket average decrease.

Restaurant margin was 16.1%, 400 basis points higher than the prior year. Occupancy and Other expenses improved significantly year-over-year. This was primarily due to operating leverage derived from higher sales and ongoing benefits of cost structure rebasing efforts. These were partially offset by lapping last year's austerity measures, increased promotional activities and wage inflation.

Let me now go through the key items. Cost of sales was 30.7%, 20 basis points lower than the prior year. We kept our cost of sales low despite increased promotional activities to drive traffic. Our supply chain team's hard work and innovative use of affordable ingredients contributed to the favorable commodity pricing. Cost of labor was 26.4%, 70 basis points lower than the prior year. This was driven by operating leverage from sales growth, lower rider costs due to lower delivery sales mix and benefits from store management sharing initiatives. This more than offset wage inflation, the lapping of austerity measures and temporary relief last year.

Occupancy and Other was 26.8%, 310 basis points lower than the prior year. Rental expense and depreciation improved year-over-year. Operating leverage from higher sales, store portfolio optimization and more favorable new store rental terms all contributed to the improvement. This was offset by lapping austerity measures and higher rental relief last year.

G&A expenses increased 15% year-over-year in constant currency, mainly from higher performance-based incentive accruals and merit increases. Operating profit was $257 million, more than tripled year-over-year. Our effective tax rate was 24.7%. We continue to expect our full year effective tax rate to be around 30%. Net income was $197 million, increasing 138% in reported currency. Diluted EPS was $0.47, increasing 135% in reported currency. We generated $417 million in operating cash flows and $264 million in free cash flows. We returned $116 million to shareholders in cash dividends and share repurchases. At the end of the second quarter, we had around $3 billion in cash and short-term investments and another $1.2 billion in long-term bank deposits and notes to benefit from better interest rates.

Now, let's turn to our outlook for the third quarter. Driving sales remains our top priority. As Joey mentioned earlier, we are stepping up promotional activities and have planned attractive offers with great food at compelling values. We are also lining up exciting marketing campaigns and resources to support those initiatives to capture peak summer holiday sales.

In terms of store openings, with healthy store economics and a robust store pipeline, we are confident to achieve 1,100 to 1,300 net new stores in the full year. Our team has put tremendous efforts into developing multiple store formats, lowering CapEx and securing more favorable lease terms. We opened 655 net new stores in the first half of 2023. Our new stores have maintained a healthy payback of 2 years for KFC and 3 years for Pizza Hut. This gives us confidence to expand across different city tiers and regions.

Regarding margins, our store network expansion and our cost structure rebasing efforts over the past few years have positioned us well to capture both sales and drive operational leverage since the reopening. With 40% of our current stores opened after 2019, we are opening an average of 1 new store every 5 hours. Our store portfolio is well-suited to operate efficiently in the evolving market conditions. We expect our effort on efficiency improvements and cost structure rebasing to continue to benefit profitability in the long term.

We note that last year's record third quarter restaurant margin set a relatively high benchmark due to austerity measures and $30 million of temporary relief in the prior year. We also expect summer hiring to normalize and wage inflation of low to mid-single digits in the second half.

Despite macro uncertainty and volatility in the near term, our multiple scenario planning capabilities and agility position us well to capture opportunities in good times and manage the downside in bad times. We continue to focus on driving sales, improving operational efficiency and investing in digital and supply chain for long-term growth.

Before I conclude, I would like to highlight our upcoming Yum China Investor Day to be held in September in Xian, China. Joey and myself, along with our leadership team, including our KFC and Pizza Hut brand managers, will share updates on our strategic priorities. We have also planned food tasting during visits to our restaurants, logistics center and digital center. Through this event, investors and analysts can gain firsthand insights into the market and our business. So, we look forward to hosting you in Xian.

With that, I will pass you back to Michelle. Michelle?

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

Thank you, Andy. If you are interested in attending our Investor Day in person, please reach out to the Investor Relations team. Now we will open the call for questions. (Operator Instructions). Ashley, please start the Q&A.

QUESTIONS AND ANSWERS

Operator

Thank you. (Operator Instructions) Your first question comes from Michelle Cheng with Goldman Sachs.

Michelle Cheng ***Goldman Sachs Group, Inc., Research Division - Co-head of Asia Consumer Research***

Joey, Andy, congrats again for the very strong results. My question is about the promotion and the competition. So as you mentioned, the market is still very promotional. And also, we hear some smaller players are actually coming back. So on one side, can you discuss or share with us your observation on the competition side? And more specifically on the margin, we still see the food cost margin managed pretty well. And particularly, can you talk about Pizza Hut since we have been working on these value propositions for many years. But it looks like in this quarter, the food cost control is pretty decent. So, can you also share with us how should we think about this pricing strategy and also further savings on the food cost?

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

Michelle, I'll talk about the promotion and competition, and Andy will handle the margin question. Customers are very value conscious for sure. But at the same time, it's not enough if we just focus on promotion; it has to be fun, promotion and good food. And our focus is to focus on effective promotion platforms. So, the famous one, Crazy Thursday is very, very fun. It's user-generated content these days. And of course, the food there is good. So, we have some new food like spring rolls, not only normal spring rolls, but skinny spring rolls. When the spring roll is smaller, they actually taste better. You can try our KFC spring rolls on Crazy Thursday.

And then Pizza Hut is focusing on Scream Wednesdays. Again, it's a very powerful message, a very simple message, great food and great offers -- from steak to pizza. And Taco Bell focused on Taco Tuesday. So, not only just random promotion, but very focused promotion and we keep doing it again and again and again. It takes time to build, to have the effect. Little do people remember, but Crazy Thursday started back in 2018. So, by now, it's a very familiar mechanism that works beautifully. And of course, we continue to build new promotional platforms. For KFC, the new one will be Buy More Save More on Sunday, and that has a clear product focus, the Whole Chicken. During normal times, the chicken sells for 39 RMB, but on Sunday during the weekend it sells for 29 RMB. So, it's not only promotion but great food.

Also, I think what people don't also necessarily correlate how we differentiate from our competitors in driving these promotions. We have the unique advantage of having our own very effective, powerful, agile, and nimble supply chain. Because without the supply chain capabilities to source, to innovate and to deliver all these very affordable ingredients, is almost impossible to support this kind of promotion on a sustainable basis.

Last but not least, operation team. On June 1 Children's Day, we achieved 8.5 million transaction a day. That's a huge number of transactions. And the fact that our operation team can handle that is amazing. For people who are running the restaurants in operation, you would be able to appreciate how difficult it is to be able to handle the peak and the spike for the IT system to not go down. We can continue to push our system in terms of the stability and efficiency.

So, that all comes together. It's not just marketing promotion. It's supply chain, it's digital, it's operations. And while many competitors can probably replicate the marketing campaigns, the operations, the supply chain, digital, these are the real top core capabilities that are very difficult to replicate.

So, I'll pause here and move on to margin question.

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

Okay. Thanks, Joey. So, in the second quarter improvement in terms of margins, I think obviously, the #1 driver is the operational leverage from higher sales. And also, if you look at the overall margin improvement, it continued to benefit from our portfolio optimization over the past few years. As I mentioned earlier, if you look at our portfolio, currently, 40% of our stores are opened after 2019 and they are very much geared towards working efficiently in our current operating environment. Also, we continue to benefit from the cost structure rebasing that we initiated over the past couple years. And so those are a key driver for margin improvement. And I think it position us well for the long term to operate efficiently.

Secondly, if you look at particularly on cost of sales, I think overall, if you look at commodity pricing in the second quarter was slightly favorable with overall commodity inflation being favorable, but the chicken price, chicken price in the second quarter, actually continued to experience an upward trend. And given the stock price and also our contract, we expect that to probably expand into the third quarter. So, I think for both brands, they manage their COS very well over the past few years. Generally, we will be balancing to expand the pricing range so that we can continue to expand our addressable customer base and balancing commodity price and also the value proposition to consumer. And we generally try to return some of the savings to our consumer.

So if you look at cost of labor, it also improved 70 basis points in the quarter. And again, like it's driven by the cost structure rebasing that we have. And then also, as Joey mentioned, we have the store management sharing initiatives that continue to help us run our stores efficiently. And that's more than offset the low single-digit labor inflation in the second quarter we experienced. And then, if you look at O&O as we mentioned, biggest improvement over the past few years, we continue to structurally change our rental contract. Not only do we have more variable components of that rental term, but also overall rent as a percent of revenue at decade low, right, best in the decade.

And so I think our structural changes will continue to benefit us and also in terms of depreciation and also as we work down our capital investment per store, that's also very sustainable, I think, and then look at our initiative in energy savings and also we benefit from our investment in technology so that in our AMP, we're seeing some leverage. And so all that contributes to O&O improvement. So, I think that's how we look at it.

In terms of outlook, I think as we mentioned, commodities are generally are favorable with the exception perhaps with chicken price in next quarter. In terms of labor cost inflation, I think we're looking at low- to mid-single digit in the second half of this year. And again, like -- but one thing I wanted to again emphasize a little bit is that last year, it was a special situation. Obviously, we received about $30 million of one-time relief due to COVID situation last year. And then we also have some cost saving programs. So, that's it. Thanks.

Operator

Your next question comes from Brian Bittner with Oppenheimer & Company.

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

I just want to ask about the sales trends. Andy, you mentioned that May saw a step back in demand trends, but then you regained momentum in June. Can you just add some context here? Could you perhaps talk about where your underlying trends are versus '19? Or anything else regarding perhaps the consumer environment in China that you're witnessing right now? Just to help us all get on the same page with modeling sales moving forward.

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

Okay. Brian, thanks for the questions. I think, as we mentioned, we are pretty early still in the reopening. This is the second quarter since the reopening. So we're going to -- probably going to continue to see some volatilities and whatnot. Obviously, the decline in -- or the softening in demand in May had to do with a couple of things. One, we've seen an uptick in COVID at the end of April, starting at the end of April. And then the other one is, obviously, you probably have seen some of the economic data and indicators that the macroeconomic situation is still relatively challenging.

So continue -- so consumer obviously have experienced three-years of COVID and would likely going to take some time to regain some of the confidence. And so that's what we're seeing right now. But as we mentioned, we have multiple scenario planning as always. So, we take quick actions as we see the change in consumer behavior. We have very strong product offering and successful campaign. And that, as we mentioned, revitalized the sales momentum in June. And I think, again, I think in the near term, there's going to be some volatility and uncertainty, but I think we are well positioned to capture the opportunity when it emerges and then able to respond quickly should the situation become a little bit more challenging.

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

Brian, thank you. Let me give an overall picture of the business that might help understand the sales trend right now as well. Overall, I would strongly suggest our investors and analysts to really look at the business with a fresh pair of eyes because the business is a rather different business now compared to pre-pandemic. We might not be obvious enough, but 40% of our current store did not exist before pandemic. So, the same-store sales really only apply to a bit more than half of our business now because 40% of the stores are new.

And even for the portfolio that existed before 2019, the business is very different too, because the management team has taken the opportunity in the last few years of pandemic to prune the portfolio, particularly those stores with less desirable economics. So overall, the portfolio is better. But even for the stores that have survived the pruning process, you bet the economics are much better with lower rent, et cetera, et cetera. And the big historical problem that we have, we used the pandemic time to sort them out as much as possible.

On top of that, we have rebased the cost structure. We have completed the end-to-end digitization and also digitalization of the entire supply chain process. So the business is more resilient, more nimble and with better cost structure for the entire company, but also for the store economics for each store. So, it's very different. Therefore the system sales growth is quite good and same as the profitability, and that's what we wanted.

Going forward, in terms of outlook, Andy talked about Q2, Q2 -- Q3, obviously, we're going to focus on sales. We are very focused on growth. We're going to focus on opening more stores and then continue to focus on delicious and innovative food that really works for customer. But in the longer term, the macro in the short term, it's hard to predict from month to month basis, but China GDP has slowed down to growing probably twice as fast as other developed countries. It's not too bad, isn't it? And then it's an amazing big market and we still serve 2 billion customers a year. And certain regional growth like in the middle of China is very nice. The growth is very good, and therefore, we are able to open stores very fast, particularly in these, what we call, new bread basket.

So what does that mean to KFC and Pizza Hut. KFC, you can see from our speed of store openings in the last few years, we are opening a lot of stores and we are reaching 9,500 stores in China alone for KFC and Shanghai alone is 500 stores. And we're not only just opening a store in lower-tier cities, we are actually opening stores in all tier cities. We are utilizing franchising. We are utilizing different channels such as some channels are newly found opportunities such as university and hospital and high-speed railway service station and it worked.

And then Pizza Hut is really ready to accelerate the growth after a few years of turnaround, the margin is good. And it surpassed 3,000 store mark for casual dining, which is quite difficult to get to in terms of scale, in terms of casual dining. So, the smaller brands are also developing and Lavazza just reached a 100-store milestone and also started to sell coffee bean in retail. So going forward, we are committed, we are optimistic. And therefore, you can see our net new store opening this year is still at the rate that is a record for our business in the last 36 years. Thank you, Brian.

Operator

Your next question comes from Chen Luo with Bank of America.

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

My question is on margin as well. So, if we combine first half this year with second half last year and actually, it would imply a 4 quarter margin of close to 17% at the restaurant level. So, I remember many years ago, we talked about the long-term normalized restaurant margin of 17%. I know we no longer talk about long-term market -- long-term target. The market usually will still look at the 17% as a reference. But now we are almost there. How much upside are we going to see from here? In particular, as Andy mentioned previously, starting from Q3, we are going to see pretty high lapping for margins. Is it fair to say that from now on, the low-hanging fruits from cost rebasing is no longer that strong. And the majority of the margin expansion will come from the same-store sales or sales leveraging in the future?

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

Chen, thank you for your questions. It's wonderful questions and then it's also wonderful questions of as you mentioned, the issue to deal with, right? Because after the reopening, after all those restructuring, cost structure rebasing that we have performed over the past few years, after, as Joey mentioned, our portfolio change entirely different, almost entirely different store portfolio. We are now obviously at multi-year, right, I think at least 5 years, if not all-time high in terms of margin. And so we're operating very efficiently at this point. And as mentioned, even despite the near-term volatility and challenges in the market, we are operating very efficiently.

And so I think a couple of things that I want to mention. If you look at the cost structure we're rebasing as we mentioned, those are very fundamental changes in terms of how we operate our restaurant and also the cost structure itself. Now in terms of 17% and margins, I'm glad that you mentioned over the past four quarter, if you average out, it's almost there. We don't give guidance on margins, but we just do it sometimes, right? And so we didn't mention it over the past year or 2, but I think we continue to focus on doing that. We're pretty confident in terms of our cost structure rebasing with that. We are pretty confident that our new store performance, new store economics at multi-year, I guess, offering the best in multi-year level. And so that gives us confidence in terms of our portfolio moving forward as we open more stores. So, we look forward to that improvement continuing.

However, as we always mentioned, we generally look at cost of sales. We try to maintain that stability there. The reason why we do that is because we obviously have a very innovative team that can help us mitigate some of the volatilities in commodity prices. We also use efficiently our product that we have over the years. So, fully-utilizing the resources like whole chicken, beef and then also our supply chain is tremendous. Our ability to actually lock in long-term contracts, for example, coffee bean prices over the last couple of years were volatile and we were able to lock in 2 year contracts. However, we've always been very cautious about pricing and price increase. And because the reason is that we want to make sure that our consumer continue to benefit from cost saving and also enjoy great value from our food. So we generally try to keep COS relatively stable.

And still, I think for COL we have initiatives to continue to improve labor productivity improvement. As we mentioned, we have the store management sharing initiative. We continue to invest in technologies and enable our team member to work more efficiently in the restaurant. But we have got to also look at the ongoing sort of labor inflation it's a fight in our industry, right? We always have to deal with labor cost inflation over time. So we generally, also try to keep that relatively stable. Now as I mentioned, O&O have improved over the years and not only in the last couple of years, but even over the past 5 years, 10 years. And so as we mentioned, we are at pretty, pretty efficient level, but we see continued room for improvement. So that's genuinely how we look at the overall margin. Obviously, the next quarter or so there was some anomaly on a year-over-year basis because of last year's temporary relief and austerity program. But overall, I think our trajectory is the right trajectory.

Operator

Your next question comes from Anne Ling with Jefferies.

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

I have -- firstly, also on the restaurant margins. With Pizza Hut improving and success in the restructuring, what would be the normalized restaurant margin would be over time? Can it be like without -- let's say, can it be as high as KFC is like 18% plus? And if that's the case, what are the drivers? Is it more on the scale of the whole network? Or is it more on like driving the sales per store for further normalization? And Joey, last time mentioned that in the previous call that you would love to see further increase in the delivery or takeaway business for the Pizza Hut side. Any strategy that we can facilitate this?

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

Anne, yes, thank you for your questions. Regarding Pizza Hut, we're very happy to see that the revitalization program have achieved very strong results over the last 2 quarters already. We continue to see very strong traffic growth. We continue to see strong sales growth. And as Joey mentioned, there are fantastic products that are coming out from Pizza Hut. And also pizza -- over the past few years, as we have kept pricing stable, have continued to improve its value proposition to consumers. The value is great. And then if you look at the brand, it's resonating really well with consumer as well, and especially with some of the campaigns, Genshin and other that really connect with our new customers.

So, I think it's wonderful that they make this transformation because I think, expand the pricing range, improve the value proposition, continue to drive the addressable market, right? So, now we're at 3,000 store level. Obviously, it has a great opportunity to grow into more store. And in fact, if you look at the store opening, store opening right now is at record level. And if you look at in the quarter alone, they probably opened more restaurants than like the last couple of years combined. And so I think that's a tremendous progress. And I think we continue to hope to see at [Pizza Hut] (corrected by company after the call) more network expansion, especially driven by satellite store and smaller store formats and then continue to build that value propositions. And then also, as they have done in the last couple of quarters, continue to improve their margins over time. But when you say normalize, I think normalized, I think right now, the margin is even higher than 2019. I don't know when we consider being normalized. But I think they're in the right trajectory for sure.

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

I think Anne, the ultimate question for Pizza Hut is not necessarily only about margins. Our goal for Pizza Hut going forward, after turnaround is to continue to work on its resiliency and growth because after turning around, that's what we want, the growth. But growth without resiliency is not too comfortable, isn't it? So, resiliency and growth. And then, of course, next step is the moat, strategic moat, right? We are very consistent with our thinking RGM. So, the question is how to get there? What's the key to unlock to get the resiliency to get more sales to manage the investment and to get profit in the short term and long term.

Well, our view of the key which we've been working on is the satellite store model. Overall, we look at the result of the new stores payback. Pizza Hut moved from 4 years to 3 years in which satellite store really delivered. These are the smaller stores focused on takeaway and delivery, which is your second question. The satellite stores do the trick and satellite store require less investment. It requires a different menu because they're mainly delivery and takeaway driven. And the profit is very good and the payback is 2 years. So, when we put the satellite store and the other stores together, the overall payback is 3 years.

So, we have found the key, which is satellite store. We just need the time to build more, and more and more and more from top tier cities, all the way to lower tier cities. And the growth story of Pizza Hut is not difficult to understand. KFC only are in 1,900 cities in China with 9,500 stores. And Pizza Hut, we only have 3,000 stores in 700~800 cities in China. So, there's more than 1,000 cities in China that have KFC, does not have Pizza Hut. So, you can see why we are quite confident about the growth potential of pizza in terms of sales, profit, resiliency. Thank you, Anne.

Operator

Thank you. Your next question comes from Lin Sijie with CICC.

Sijie Lin ***China International Capital Corporation Limited, Research Division - Analyst***

I have a follow-up question on promotion and competition. So, we think that our insistence on value for money leads to better, resilient sales recovery, but we've also seen increasing promotion and more value combos like [Weekday Value combos] (OK San Jian Tao). So do we think this is only because people are value conscious under this economic environment? Or this also has relationship with more intense competition from McDonald's, from Tastien and all other competitors? And how will this impact our ticket average and sales per store?

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

So, [Weekday Value combos] (OK San Jian Tao) is new. Right now, it's delivering about low single-digit in terms of sales mix. The key thing here is, well, of course, customers are very cautious, it doesn't hurt to open up the price range. What does that mean? In the past, we did not have that price at 19.9 RMB as a combo. When we introduced it, the most critical thing that we are looking for is incremental sales, in particular, incremental same-store sales. What's not to like? It's fantastic. It's new business for us. And then in terms of its performance across city tier, well, people might think that it worked very well in low-tier cities, actually, not really.

It worked better in top-tier cities because this is more for what we call the functional consumption for the lunch. So, it was better for the top tier city. But for lower-tier cities, it actually gives us insight. We might -- we still can open more stores. We can open more stores in low-tier city to capture that functional consumption. So, we are happy with that. And again, the key to unlock this [Weekday Value combos] (OK San Jian Tao) is ability in supply chain, whether we can source such affordable ingredient to deliver that price point and still at reasonable profit. Our teams did it.

Your next question comes from Lillian Lou with Morgan Stanley.

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

I have a follow-up question on same-store sales growth. So -- because Joey just mentioned that our store network right now is very different from pre-COVID. So when I look at the same-store sales growth compared to pre-COVID, i.e. 2019 level, in second quarter was still 10% below. But if we look at more on the holistic basis because we're adding more and more smaller stores, does that mean that actually, our same-store sales growth will be below 2019 level for a longer period of time, even though our underlying operation is already kind of close to back to normal? That's more like a mathematics problem question. And also in the operation perspective, what has been driving our same-store sales growth below normal level? In particular, is there still traffic hubs stores or in certain areas or in certain tier of cities or store format?

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

Lillian, so let me try to clarify this. Our system sales was [32%] (corrected by company after the call) year-over-year, our same-store growth was 15% year-over-year. And then if you adjust for the impact of temporary store closure last year, our system same-store sales growth, a lot of time people use that in the industry will be about 24%. So if you look at that, our adjusted like same-store sales growth would be close to 24% year-over-year. So, I think we mentioned some of the slowing down in the May period. In fact, our same-store sales growth is very robust and very strong. And obviously, the driver for the different tiers, slightly different, Joey mentioned, the lower tier cities are generally growing faster. And then -- and you mentioned about the T&T space, T&T space is very important for us and we continue to see robust recovery over there.

And if you look at the tourist locations, I think it's doing -- it's quite well, performing quite well. Even at the major transportation hub for domestic travel for high speed railroad and for domestic flight, they continue to improve. I think that trajectory is also very strong. Obviously, international travel, flight travel is a little bit softer, and then it would probably take a longer time until flight schedule get sorted out. And so I think in terms of our same-store sales growth it's pretty robust. So I don't know if Joey has anything to mention?

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

For the existing store that opened before 2019, as Andy mentioned, the transportation hub actually coming back during May and particularly during the holidays. And by the way, that's sort of another consumer behavior right now. There's consumption during the holiday and festival, amazingly well. It just in between, it's a bit more depressed, but we have a program to manage that. But for tourist location, actually have recovered really, really well, and particularly in the Tier 2 cities like Xian and whatever. So, these sort of tourist destination Tier 2 cities are doing really well, back to pre-2019 level already.

But to answer your other question about the holistic same-store sales. Well, here, the ultimate question is how to continue to grow our same-store sales, particularly when our stores are getting smaller and smaller and smaller, particularly the newly opened one because the smaller stores require less CapEx and the payback is good. Well, it's not silly, but why not growing the same-store sales outside the store then. Therefore, it's rather important to continue to drive the delivery, takeaway and that goes for both KFC and Pizza Hut and therefore, I've been emphasizing on how important it is to grow the off-premise sales and the new retail.

New retail is still low single-digits compared to the entire Yum China sales, but the absolute number is not small. It provides very nice resilient sales driver, particularly during the tough times. And let me be a bit more specific about KFC. How do we do it outside the store. If you come to China, have opportunities, particularly during our Investor Day, you will see more and more and more -- our KFC store will have a window opened up. So that you don't even need to -- customers don't even need to go inside the store to get your coffee or ice cream or whatever snack or meal. And that improved convenience helps and you bet we are doing at scale whenever we could.

And then you will see more coffee trucks or standalone coffee. Well, the sales grows nicely, but if we look at KFC coffee compared to last year, it only increased by 50%, which is not too bad, isn't it? And the coffee truck investment is low. It's lovely, it's so cute in any tourist location or anywhere without a fixed location. It's okay. So, we only have about 200 right now, but you bet we're going to have more. And then during the holiday and festivals, there are popup stores. Well, actually, it's not something new, we just don't talk enough about it. We do a lot of the popup stores during Chinese New Year. And right now, it works for holiday and festival too.

So it doesn't matter, well, to a certainly extent matters, but we don't want the size of the store to limit our same-store growth because we can go outside. You will see more and more and more breakfast kiosks around the store these days, it worked both for KFC and Pizza Hut. Even though it's already very convenient to pick up breakfast from our store, we further improved the convenience by bringing the breakfast to the subway station, et cetera, et cetera. So, I hope that gives you a sense about how do we drive the holistic same-store sales despite our stores are getting smaller.

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***

Thank you management for the presentation as well as answering most of the questions I think investors care about. So, I have a very quick question regarding the capital allocation. So, if you look at the first half 2023 cash, free cash flow, basically, all the measures suggest that the cash accumulation for the company has been very strong. But as we look at the cash dividends and share repurchases, it was not really suggesting a big pickup compared with the pandemic period. So I was just trying to understand what's the logic behind this? And what's the future thought in terms of distributing more cash towards the investors?

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

Thank you, Christine. I think a couple of things. One is that our capital allocation, as always, is focusing on driving organic growth. And so it's on store openings, it's on store remodeling that generally capture more than 60% of our CapEx spending. And then we also look into investing obviously in our new brands and also digital and supply chain to make sure that we continue to run our operations effectively, efficiently and also actively, so that we can deal with different uncertainties.

The other one is for cash allocation, obviously, we want to have a strong balance sheet to make sure that we can deal with any contingencies that may come up. Occasionally, opportunistically, we look at investment, a special investment that would boost our capabilities, both in the technologies, in our store operations and our supply chain. We are very committed to returning capital to shareholders. If you look at in the quarter, we have returned more than $110 million to shareholders. The pace of share repurchase, obviously will vary depend on a number of factors. But I think we hold a very strong commitment to return excess cash to shareholders.

Dividends, as we have done so in the first quarter of this year, we have raised dividends at the early part of this year by almost 8%, 9%. And so we will revisit our dividend policy with our Board every quarter and every year. And so -- but again, we are very glad, our strong operating performance generate good operating cash flow and good free cash flow in the second quarter and the first half of this year. And so we'll continue, we will continue to return that excess cash to shareholders for sure. Thanks, Christine.

Operator

Thank you. That is all the time we have for questions today. I'll now hand back to Ms. Michelle Shen for closing remarks.

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

Thank you for joining the call today. If you have further questions, please reach out through the contact information in our earnings release and on our website. Thank you.

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

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