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PRESENTATION

Operator

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

After the speakers' presentation, there will be a question-and-answer session. (Operator Instructions)

I'd now like to hand the conference over to your first speaker, Florence Lip, Senior Director, Investor Relations of Yum China. Thank you. Please go ahead.

Florence Lip ***Yum China Holdings, Inc. - Senior Director of IR***

Thank you, Tara. Hello, everyone. Thank you for joining Yum China's First Quarter 2022 Earnings Conference Call. Joining us on today's call are our CEO, Ms. Joey Wat; and our CFO, Mr. Andy Yeung.

Due to the current COVID restrictions in Shanghai, we are dialing in from different locations today. If we experience a technical difficulty 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 presentation contain forward-looking statements, which are subject to future events and uncertainties. Our actual results may differ materially from these forward-looking statements. All forward-looking statements should be considered in conjunction with the cautionary statement in our earnings release and the risk factors included in our filings with the SEC.

This call also includes certain non-GAAP financial measures. You should carefully consider the comparable GAAP measures. 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 first quarter. Andy will then cover the financial performance and outlook in greater detail. Finally, we will open the call to questions. You can find the webcast of this call and a PowerPoint presentation which contains operational and financial information for the quarter 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 & Director***

Thank you, Florence. Hello, everyone, and thank you for joining us today.

We are battling the most severe outbreak since COVID-19 first emerged 2 years ago. The challenges we face are unprecedented. The case count, duration, geographical coverage and restrictive measures are far more extensive than previous outbreaks. Shanghai, Tianjin, Jilin and Guangdong were among the places to experience extended periods of lockdown. Shanghai, one of the most impacted cities, has been locked down for more than a month now. Our operational headquarters in Shanghai are all working remotely. Hundreds of millions of people across China are currently under some level of restrictions. Even regions with few cases have tightened containment measures in line with the dynamic zero-COVID policy.

Compared to 2020, it's far more complex to keep our stores open, get our employees to work and obtain necessary approvals. Our store operations, delivery and supply chain have been heavily impacted due to ever-changing restrictions. I want to thank our frontline employees at restaurants and logistics centers, our delivery riders and our staff at the back office for working tirelessly during this difficult time. I'm extremely proud to see how quickly we adapt to each new challenge and how teams from across the company support one another. From procurement, logistics, IT, HR to public affairs, we work as one team. Our mission is to serve the community and customers in need to the best of our ability. Hundreds of our back-office staff rising to the occasion, they volunteered to serve at the frontline, supporting our restaurants. They performed health check at restaurants, delivered food using their own cars and served as customer service representatives.

Soon after the lockdown in Shanghai started, when most business activities have come to a halt, we became one of the few and first authorized food suppliers to serve the communities. While we can only offer limited services, we are prioritizing food and drinks to frontline workers, volunteers and make-shift hospitals. We also provide ready-to-eat products to the elderly living alone and KFC children's book to kids in quarantine centers.

During the lockdown, the demand for KFC and Pizza Hut products surged. Many of our customers got on social media like WeChat and Douyin, the equivalent of TikTok in China, expressing their longing for our signature products. Many of them also shared their happy moments on social media when they enjoy the KFC fried chicken or Pizza Hut pizza. I'm glad we could bring some comfort and joy to our customers in trying time like this. It also gives us energy and a renewed sense of purpose.

Health and wellness of our employees is always our top priority. We delivered over 10,000 food packages to closed-off employees. We also provide packages with essential supplies and upgrade medical plan for those who are infected. Our ability to adapt to the dynamic operating environment is at the core of our resilience. With valuable learnings from prior outbreaks, we have developed extensive scenario planning and toolkits to deal with different situations.

Nationwide, we quickly adjusted marketing campaigns and simplified menu to streamline operations. Our hybrid delivery model with dedicated riders allowed us to maintain adequate rider capacity and continue operations in most places. Delivery grew at double digits and reached 36% of company sales. Seizing the demand for home consumption, we promoted new retail packaged products such as steak, pasta and fried rice. New retail sales in the first quarter more than doubled over the prior year period.

The surge of Omicron cases and ensuing lockdown have turned everything upside down for us in Shanghai. Despite the citywide lockdown, we were able to keep about 10% to 15% of our stores open for delivery or takeaway in April. To serve as many communities as possible when mobility is heavily restricted, we introduced community purchasing across all brands as early as mid-March. This is a new way to group orders among residents. To maximize efficiency, we focused on key menu categories, offering only a few preset combos. We also promoted new retail packaged foods, which are perfect items, ready to eat and easy to store under this circumstance. The retail sales mix in April surged to over 15% in Shanghai.

By swiftly implementing these initiatives, we were able to generate 40% to 50% of pre-lockdown level of sales in Shanghai despite having very limited stores offering off-premises services only. In other words, 10% to 15% of our stores generated 40% to 50% of our pre-lockdown sales in Shanghai.

Community purchase creates new business opportunity for our brand. KFC optimized its community purchasing menu to just one item, the fried chicken combo, as it is one of the most desired food items during lockdown. Our customers share their appreciation on social media, quoting that having KFC fried chicken is the happiest moment in the last month and our fried chicken is a comfort food and nourishment of the soul. People are craving for KFC, and we are working our best to fulfill them. We also look forward to serving customers at our restaurant when they come to satisfy their craving after the lockdown.

Pizza Hut was one of the few places to order hot pizza during lockdown. To meet the demand, we simplified the menu to combos with 2 pizzas, fried rice and ready-to-cook steak and pasta. Our customers were so excited to receive our high-quality, well-packaged and safe products during lockdown.

Community purchasing presented fantastic cross-selling opportunities and increased brand awareness for our emerging brands. These brands captured a significant portion of sales compared to the level before lockdown with signature products and packaged food offering even when only a few stores were opened in Shanghai.

For example, Lavazza offered packaged cheese and ham in addition to its famous coffee and pastries. Taco Bell served hot quesadillas, fried chicken and breakfast DIY package. Little Sheep offered takeaway hot pot with meats and fresh vegetables, highly sought-after items during lockdown.

Let's move on to supply chain and digital. Our industry-leading supply chain and digital capabilities are critical business enablers to fulfill ever-changing demand. Our in-house supply chain team work wonders in difficult situations like this. We quickly introduced strategic redundancy in our supply chain with backups in different logistics centers to lessen the impact of supply chain disruptions and to allow us to continue operations.

We immediately designed a 200-kilometer detour route to ensure supply to logistics centers in Eastern China. Instead of just using trucks, we move inventories by rail and sea freight as well. In just a few days, we set up a temporary drop-off and pickup sites not far from Shanghai to support the region under lockdown. We also repurposed ingredients from one product to another and reallocate inventory across restaurants and even brands to fully utilize our resources and minimize wastage.

Digital enable us to put innovative ideas into action. Since March, we cut back on advertising. We leveraged our membership program and our own channels to digitally engage our customers. We rapidly launched a digital mini program to make community purchasing easier. Our digital infrastructure provides real-time visibility to store inventory, allowing us to precisely forecast the material demand, manage supply chain routes and minimize food wastage.

(technical difficulty)

Operator

Ladies and gentlemen, it appears that Joey has dropped from the call. Please stand by while she reconnects the line.

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

Hello? The line just dropped, and I just called back. Can you hear me?

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

Yes, Joey. Please go ahead.

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

Yes. I hope by now, you have a better picture of the challenges that we face and even in situations like this, how we find ways to serve our customers and communities. This is the third year for the COVID pandemic, so it is understandable that pandemic fatigue may be setting in.

I'm very proud of our team members. They have been courageous and continue to maintain a positive attitude in face of adversity. The pandemic will surely pass, and our business will recover. As we look ahead, I'm confident that as long as we focus on new opportunities, remain innovative, be bold with our initiatives, be agile in our action and control our cost structure, we can get through this challenging time and become even stronger. We remain confident in the long-term prospects in China. We will continue to invest and focus on our RGM strategy, so we can fortify our market leadership and capture the significant growth opportunities across our brands.

Before I pass to Andy, let me say a few words about changes in our leadership team. I'm pleased that Johnson Huang, previously the General Manager of KFC, is now our first Chief Customer Officer. This strategic move will better integrate customer centricity into a brand-driven culture. Johnson will focus on building capabilities to better understand and serve customers. He will spearhead cross-functional initiatives, including cross-brand customer loyalty program and delivery initiatives. He will also oversee COFFii & JOY, Lavazza and Taco Bell. With Johnson's strong technology background and deep understanding of the organization, I'm confident that he's the best leader for this role.

Warton Wang, our Chief Development Officer, succeeds Johnson as the new KFC GM. Warton joined KFC as an operations management trainee 24 years ago and worked his way up. He led various initiatives to improve KFC's business operations, innovate store formats and business model. I believe that Warton's strong leadership and deep operations experience will bring KFC to new heights. Warton's achievement as a homegrown leader will also inspire our entire frontline employees.

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. Now let me share some color on our first quarter performance.

Compared to a relatively stable January and February, the COVID situation in March rapidly deteriorated. March same-store sales declined by more than 20%. As Joey mentioned, our team put in tremendous efforts to sustain operations, mobilize and fully utilize available resources to drive sales and proactively manage costs.

We achieved a profitable quarter, demonstrating the resiliency of the business. We continued to grow by opening 329 net new stores and ending the quarter with over 12,000 units. First quarter total revenue grew 4% in reported currency to $2.7 billion. The contribution of new units and the consolidation of Hangzhou KFC was partially offset by the same-store sales decline and temporary store closures.

System sales were down 4% in constant currency. Same-store sales were 92% of prior year's level. By brand, KFC same-store sales were 91% of prior year's level with same-store traffic at 86%. Average ticket grew 6% mainly due to the increase in delivery mix, which has a higher average ticket than dine-in. Pizza Hut same-store sales were 95% of prior year's level, same-store traffic was at 97%, while average ticket was down by 2%. This was driven by the increased mix of delivery, which has a lower average ticket than dine-in.

Restaurant margin was 13.8%, down 490 basis points compared to last year. This was mainly due to sales deleveraging higher commodity prices and wage inflation as well as higher delivery costs due to increasing delivery volume.

Now let me go through each expense line item. Cost of sales was 31.1%, 90 basis points higher than last year. This was mainly due to commodity inflation. We also incurred higher logistics costs and wastage due to the regional outbreaks. Cost of labor was 26.2%, [290] (corrected by the company after the call) basis points higher than last year. This is due to sales deleveraging, wage inflation of 5% and higher delivery rider cost from higher delivery mix. Occupancy and others was 28.9%, 110 basis points higher than last year mainly attributable to the sales leveraging impact and 10% increase in utility prices. The impact was partially mitigated by proactive savings in advertising expenses. G&A expenses increased 14% year-over-year in constant currency mainly due to consolidation of Hangzhou KFC and Lavazza as well as increased compensation and benefit expenses.

Operating profit was $191 million. Solid performance in January and February enabled us to achieve a profitable quarter. The net contribution from Hangzhou KFC's consolidation was 5% of operating profit in the quarter. It also includes the amortization of intangible assets acquired, roughly $16 million per quarter that went through the end of this year. Below the operating profit line, we incurred a $30 million mark-to-market net loss on our equity investment this quarter. It was $14 million more than the same period last year.

Our effective tax rate was 33.1%. The higher tax rate is mainly due to lower pretax income and the Hangzhou KFC consolidation. Prior to consolidation, the equity income from JVs was not subject to tax, resulting in a lower tax rate. These factors will likely continue to impact the effective tax rate for the rest of the year. Therefore, we expect full year effective tax rate to be low to mid-30s. Net income was $100 million. Diluted EPS was $0.23. The mark-to-market loss in Meituan negatively impacted diluted EPS by $0.07.

Let's now turn our attention to the outlook for the second quarter 2022. As the COVID situation deteriorates, we faced even stronger headwinds in the second quarter. Eastern China, the most economically vibrant regions in China, is severely impacted this time. Eastern China is also our most important market, accounting for around 30% to 40% of our store mix and sales mix.

Apart from Shanghai, many large cities, such as Guangzhou, Suzhou, Tianjin, Changchun and Xian were also partially locked down in April. Strict preventive measures are in place nationwide, significantly limiting social activities and mobility. For example, during the Labor Day holiday in Beijing, restaurants provided only off-premise services. Residents are required to provide proof of a negative PCR test to enter public venues.

Consumer spending has also been weak. Non-manufacturing PMI dropped from 48 in March to 42 in April according to government statistics. This was the lowest and steepest reduction since February 2020.

In April, our same-store sales declined more than 20%. In addition, around 3,000 stores were temporarily closed or provided only delivery or takeaway services, significantly more than March. Around half of temporary -- half was temporary closures.

As a reminder, stores providing only delivery and takeaway services are included in our same-store sales calculation. Temporary closure are excluded from the same-store sales calculation during their closure period but would negatively impact system sales and revenue.

Margins are expected to be pressured further in the second quarter. Significant sales decline is expected due to the worsening COVID outbreak. Sales deleveraging impact will be more pronounced too as sales and margins are seasonally lower in the second quarter. Furthermore, we continue to face several cost headwinds, including the surge in commodity prices, wages and utility prices. The increase in delivery sales mix will also increase rider costs.

The current situation is very challenging. We incurred loss in March. Barring a significant improvement in external conditions in May and June, we expect to operate at a loss in the second quarter. We are taking actions to lessen the short-term impact. In addition to what Joey mentioned, we are adjusting our marketing events and promotional activities, temporarily postponing store remodels, negotiating rent relief, optimizing raw material cost structure and implementing G&A austerity. We quickly deployed various initiatives across the country while staying flexible depending on local conditions.

Now looking past the very tough business environment in the near term, our efforts will have a long-term positive impact. We have strengthened our brand equities and bonded with our customer. We have also gained valuable experience and developed toolkits to help us navigate different situations. Our business model is even more agile and resilient than before. We have made important breakthroughs in community purchase and new retail. We will continue to make constructive and strategic changes to seize market opportunities as they arise.

We're here in China for the long run. Powered by healthy store economics, we are confident to further expand our store network, KFC and Pizza Hut new store making healthy store payback at 2 years and 3 year, respectively. The majority of store opened in 2021 also achieved monthly breakeven within the first 3 months. While we expect a slower pace of store openings in the second quarter due to COVID, we still intend to achieve our full year target of 1,000 to 1,200 net new units. We will continue with our systematic and disciplined approach and prudently evaluate the situation.

Also, I'm pleased to share that we have entered into an agreement with Yum! Brands to jointly step-up investment in accelerating Taco Bell's store growth in China. We are committed to expanding the Taco Bell store network to at least 100 stores by the end of this year and at least 225 stores by the end of 2025. In turn, Yum China will have the exclusive right to operate the brand in China for 50 years. I'm confident in Taco Bell's long-term potential in China.

Now turning to capital allocation. The Board of Directors expanded the authorization of share repurchases by $1 billion in March to an aggregate of $2.4 billion. At the end of the first quarter, our remaining authorization was approximately $1.4 billion. We returned over $280 million to shareholders in cash dividends and share buybacks in the first quarter. We continue to employ a disciplined and balanced capital allocation strategy.

As I mentioned before, our priority is to have sufficient cash for daily operations and to deal with contingencies. We will continue to make significant CapEx investments in digital, supply chain infrastructure and our store network expansions. We are confident that this investment will widen our strategic moat, drive sustainable growth and capture attractive long-term opportunities in China.

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

Florence Lip ***Yum China Holdings, Inc. - Senior Director of IR***

Thanks, Andy. We will now open the call for questions. Operator, could you please start the Q&A?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Sijie Lin at CICC.

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

So I have 2 questions. The first is the multiple waves of COVID outbreak, especially the Omicron this year, it's a very difficult situation for market players in the whole restaurant industry. So regarding the impact on industry supply, what's your observation? If there were many closures of mom-and-pops during last 2 years, are we seeing more small- and medium-sized chains with difficulties this year?

And my second question is, could you please give us more color on the promotion strategy at the current stage? What's the difference compared to last 2 years considering the evolving situation?

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

Thank you, Sijie. Let me share some thoughts here. First of all, we are very grateful with our own business model. This is -- Yum China, particularly KFC and Pizza Hut, has a fantastic business model that we can do well when the time is good, but it's also proven again and again during challenging times this is a very resilient business model. So we are very grateful, and we still can capture 40% to 50% of sales in Shanghai with 10% to 15% of stores.

In terms of competitive landscape, it's still a bit difficult to tell particularly in Shanghai or locked-down cities because we are still going through it. But I think this is definitely the time that differentiates the company with solid operating capability and also prudent financial arrangement versus the others. So fortunately, I think for Yum China, both our operation and digital capabilities and also our prudent financial philosophy help us through the difficult time.

In terms of promotion strategies, we have multiple scenarios. So while the -- for nationwide, the sales is under pressure, but for the country -- for the city and the province that are still going on with our normal business operations, the business is still as usual. We still pursue good products with fantastic values, with promotion. And recently, we just launched the entry-level beef burger priced at CNY 19. And for Pizza Hut, we just launched the new menu for the year, which is, again, 40% improvement of the menu items on the menu. So this is still going on, and we still have like our very famous Crazy Thursday for KFC and Scream Wednesday for Pizza Hut as value program.

But for cities that are in lockdown such as Shanghai or Guangzhou or Shenzhen, we pulled back the promotion because the focus is about maximizing our limited resources to meet the customers' unmet needs. Here, we really have the unmet needs because rather small percentage of our stores can open. And we also pulled back our menu. As I mentioned earlier, in KFC's case, we only offer one combo, which is fried chicken. We don't have burger, we don't have fries, just fried chicken with some Pepsi cola. And then for Pizza Hut, there are 2 pizzas, the very famous [supreme and pepperoni.] (added by the company after the call)

(technical difficulty)

Operator

Sorry, ladies and gentlemen, it looks like Joey's line has dropped once again. Please stand by. Thank you, Joey. You're now back on the call. Please continue.

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

Okay. We can take the next question.

Operator

Certainly. Our next question will come from Lillian Lou at Morgan Stanley.

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

Given all the challenges the operation are facing, could you give us a bit update about the trends in Eastern and Southern area close to the end of April or May, i.e., the latest trend? Especially, I think in Southern China, it seems like the situation is better than Eastern region. If we talk about the economic importance, both regions are very important. So just to give a little bit color of the lockdown, kind of really what the impact could be.

And following on that also, because you mentioned that there is a simplified menu; and also in the normal areas, we also offer the normal menus. So I want to understand a little bit further, under such a complicated situation, how do we manage the logistics and also procurement, especially I understand that the transportation disruption bottleneck is still there?

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

Thank you. Andy has mentioned earlier about his thought and our thought about Q2 and the early May trading, so I'm going to comment on the trading pattern. Let me take KFC as an example to help sort of understand the overall big picture. The dine-in sales definitely dropped very significantly. The delivery has come up, and we can understand that.

Nationwide, we drove growth through our hybrid delivery model with our own rider. As I mentioned earlier, in Shanghai's case, when we don't have enough rider or our riders have been quarantined, our own back-office staff volunteer to deliver whenever we could if we can get the license or approval to go out and deliver. So that's the dine-in versus delivery.

And then the transportation hub, as you can imagine, really suffer. The transportation hub, like the train station, et cetera, the train right now is about 50% below the pre-COVID level, which is before -- compared to 2020. Non-transportation location also declined because the decline is nationwide.

And then in terms of weekend versus weekday, weekend is doing slightly better because it's a bit more functional. Sorry, weekday is a bit more better because it's functional. Weekend is a bit -- is slightly a bit weaker relatively speaking.

And then lower-tier cities are doing slightly better because they are less impacted by the transportation hub. And then the higher-tier city is more impacted by the regional outbreaks. And then system sales in lower-tier city also is better because of the new store opening there.

And by region, interestingly, despite the outbreak in the Southern part of China and Eastern part of China, Eastern part of China is still doing better in terms of same-store growth. It's a very resilient part of the country. And we are very focused on Eastern part of China, so this is not a bad news. So beyond the pattern of trading, I mean the similar pattern kind of -- sort of applies to Pizza Hut as well.

In terms of the logistics and procurement, as I mentioned earlier, I think our team is just absolutely amazing. And not to mention this is our own in-house logistics supply chain, and they work day and night. Our team have come up with alternative arrangement very quickly. We traditionally use trucks to move goods around, and you probably know that it has become a bit challenging to move goods around across province, so we use rail mainly to take the goods to the West and then use sea freight, we can put our goods into sea freight and send it to Tianjin to cover the Northern part of China and then to Guangzhou to cover Southern part of China.

And then our logistics center in Shanghai and Kunshan, we have both. They are working -- our team is working in sort of close-loop arrangement to keep our logistics running without major disruptions. And also because this is our in-house team, so we can move the supply between the stores and between the brands and to also minimize the wastage.

Again, it has proven our investment in supply chain and also in digital capability a very important strategic moat because now we have visibility -- digital visibility of a real-time stock so that we know exactly where stocks are, what's their expiry date. With the visibility, we can be a lot more efficient to keep up the supply as much as we could and also minimize the food wastage particularly when food is a challenge for Shanghai. So this is incredibly important.

So that's where we are. It's not easy. There are a lot of drama, a lot of challenges, but we seem to be able to adapt really quickly and be as agile as ever. I mean I'm sure some of these innovations will help us in the long term as well.

And then not to mention other than logistics and procurement, all these things, what really help is externally our innovations in new retail. We have been incubating the new retail business for 2 years now. It's a brand called SoulFun. We've been doing that for a few years now. And by second week of March, we can see the potential opportunity in new retail when Shanghai was in sort of soft lockdown. And literally within few days, we come up with the initiative of community purchasing across all the brands, not only KFC, Pizza Hut but Lavazza and Taco Bell and Little Sheep, all the brands, and we do it together.

And original community purchasing is only a hotline. Later on, we have the -- when I say later on, I need a few days later. We have the mini app. And then we have the ready-to-eat, ready-to-heat, ready-to-cook products. And the packaged food also allow us to be more efficient with the logistics process because the new retail packaged food, these are much better food to store and to move around in bulk.

So I'll pause where we are. And with this challenge comes opportunity because Yum China is very well positioned to capitalize with extensive store network, our membership, our online channel and already-established channels via third parties such as JD.com or Tmall for the new retail as well. So I pause here and save some time for the next question, okay? Thank you, Lillian.

Operator

(Operator Instructions) Our next question will come from Anne Ling at Jefferies.

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

Just a follow-up regarding the same-store sales comment that Joey just mentioned, that the same-store sales was better in Eastern part of China despite all these like constraints and lockdown, so meaning that the other -- for the rest of the nation, we are seeing like a much weaker same-store sales trend. I just want to check with management what is the take on this. Is it like -- does it mean that there's more fundamental issues regarding like consumer sentiment or some underlying structural issue which we should continue to worry about even when the COVID situation start to subside on this and on that?

And we're also seeing like the membership sales as a percentage of sales was lower on a quarter-on-quarter basis. So does it mean that during this period we have more new customers? If that's the case, how are we able to capture these and turn it into our members? And if it is not the case, how are we going to remedy that?

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

Anne, this is Andy. I think I will take your question. I think the first question is about the regional differences between Eastern China and the rest of the country. I think there's a couple of things. One is, obviously, we're referring to the overall Eastern part of China not impacted by -- well, that's not significantly impacted by the COVID situation. For example, Shanghai, obviously, because of the lockdown, is significantly below the national average. And so I think what we're referring to is the overall situation in Eastern China outside of Shanghai is probably still performing quite robustly.

So I think it probably had to do with the overall economic vibrancy here in Eastern China. As you know, Eastern China is the most vibrant, economically speaking, region in the country, account for a big part of GDP, a very strong growth rate. And we see that the wealth distribution is also quite evenly distributed. So that's why we continue to see Eastern China as a very important and a very good growth market for us.

Now obviously, there's some regional differences. For example, Northeastern part of China this year and over the last couple of years had been hit by wave after wave of COVID. And so I think overall economically speaking, the Northeastern part of China is also less vibrant when compared to, for example, Eastern China. So I think that generally, there's some regional differences. And obviously, our strategy, our store network expansion would also factor that in as we open new store.

Now I think the other question is about the sales decline. I think it's very important to keep in mind the same-store sales decline in recent months driven are by COVID surge, Omicron surge, which resulting in very strict preventive measure and health measures. That, I have to say, as I mentioned on my prepared remarks, have an impact on the restaurant industry but also on obviously the non-manufacturing service sectors in China as well and also the manufacturing sectors. So I think it's worth keeping in mind the temporary or the short-term nature of this.

If you look at -- we're confident. We're doing a lot of things, obviously, to try to address the short-term challenges both in terms of how to use our existing resources. One, obviously, is to continue to provide service to our customers, to manage cost, value propositions and also meet the demand in the impacted regions. And then we also have cost control. As we mentioned, it's not only for the short term but also looking into cost structure in longer term, how we can emerge better.

And we're confident, if you look at long run, in China, we have very strong opportunities. There's a lot of white space still, so we can expand and grow. If you look at between second half 2020 and the first half of 2021, when things become relatively more stable, we were able to capitalize on the rebound, the recovery and also the opportunity that presents in terms of both sales and also margins. So I think it's fair to say there's a short-term piece and then sort of intermediate long term. And then longer term, we are much more confident about the market opportunity.

So Anne, hopefully, we address all your questions.

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

Right. But what I'm also referring to is on the membership sales as a percentage to system sales, where it's gone from like 64% to 62%.

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

I think like the membership sales is not always higher the better. You should understand we -- our membership continue to grow. And obviously, in this period of time, like maybe or may not be impacted. But we continue to need to have -- attract new customer. If we have 100% member sales, then that would be problematic for us in the long term because that means we're not attracting new customer to purchase at our stores.

So I think it's a healthy mix. 60-some percent in membership is already a very high number. We don't particularly pursue a number for membership sales, and we don't particularly think that having higher membership sales would necessarily be better. I think this is a healthy level, where we have a good mix of our member sales and then also a good mix of new customers coming to our store.

Operator

Our next question comes from Veronica Song at Credit Suisse.

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

This is Veronica from Credit Suisse. I have a quick question on the store expansion. So the expansion today is very well on track, and I understand that management maintains the annual expansion target for now. But may we ask what market condition or at what state will the management consider to lift or cut the annual expansion target.

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

Okay. Joey, let me address this question for Veronica.

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

Yes.

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

So in terms of our store network expansions, I think it's worthy to keep in mind that we employ a very disciplined strategy for store network expansion, and we continue to see good opportunity. That's why we continue to expand our network. And our store economics, our payback period reflect that disciplined approach and also the strong economics.

So if you look at KFC, for example, the payback period for those new stores were 2 years. And for Pizza Hut, it's about 3 years. So it's very strong economics and because we apply a consistent, disciplined approach, our results are relatively consistent. And that can happen. I think a lot of people have asked questions why it seems like we have some COVID challenge, how come your store economics and payback is still very strong. That is because over the past few years, we continue to innovate in our store model. We lower the CapEx, make us more flexible, and so we just see more opportunities, more sites available that meet our internal requirements.

Now on the other hand, I think obviously, COVID -- the new store is not immune to COVID. But I think if we look at the situation, if it is a prolonged situation, obviously, longer term, you will see that impact reflected in our payback period. Our payback period is based on sort of 12-24 month performance. So when you have a sharp impact in the short term, it may not show that up in the near term.

Now what will change in our -- the store network expansion? As we have mentioned, obviously, in the first quarter, we're going to slow the store expansion because of the COVID situation right now. Some of these is practical reasons. We also are suspending sort of like store remodeling at this time temporarily. We -- our store remodeling is in very good shape. On average, if you look at our store portfolio, the store are either new or have been remodeled over 5 years. So 80% of that is like that. So we think we can also slow that a little bit.

Unless obviously, as I mentioned, COVID situations have been very prolonged and then will impact our store unit economics, that we may go back and evaluate it. So the important thing for us, the metrics that we look after is obviously the return on our investment, the hit rate, success rate of our new store and then, obviously, going forward, how close the market is trending to our expectations. And so all these would help us to revise our model input.

So hopefully, when we look at the longer-term strategy, there's no change to it. I think the store economics is still very healthy. As I mentioned before, 2021's new store opening, they were able to reach breakeven within 3 months. So that's very healthy, and, the payback period is very healthy. So not much in the long term change our view on store network expansion, and we see a lot of space in the low-tier cities as well as potentially improving our store density in the urban area for off-premise consumptions.

Thank you, Veronica.

Operator

Our next question comes from Lina Yan at HSBC.

Hau-Yee Yan ***HSBC, Research Division - Hong Kong and China Consumer Analyst***

I think there are a lot of uncertainty in the short term, so I actually want to ask a question about the longer term. So if I look at like a KFC per-store sales per year, like in 2019, it was close to like RMB 8 million per store. And that's lower number in 2020 and even a lower number in 2021 probably because we opened more stores in lower-tier cities.

So I think like if we consider like longer term, like considering the mix of new store opening, do management have an estimate of where is the ideal like the per-store sales for KFC can settle at like in the absence of COVID situation? And also, considering the opportunity from retail, like Joey just shared the retail has -- like grow very fast. Like capacity-wise, like theoretically, what kind of retail revenue we could expect in 2022? And what is more like a medium-term target? So that's my question.

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

Thank you. Let me share some thoughts with you in this particular area. One is about the store average sales, and the other one is the new retail. So for store average sales, I would like to take a step back and share that KFC and Pizza Hut both has a range of store models. There are some big store have more seating, and there are some smaller stores that is more off-premise-driven. And this is incredibly important because if we keep chasing the average store size, then we miss the big opportunity in terms of the convenience. The reason why this is so important because, if you can see our mix of off-premises business is growing and growing, and off-premises is really driven by the store network.

And as Andy just mentioned earlier in our new store opening strategy, the store density within our current top-tier cities is incredibly important. And then of course, we are opening store in the lower-tier city as well, as you mentioned. And if you just think theoretically within the same 5 kilometer, if I have more store there, then the convenience and the speed of delivery is much higher and more efficient. So we will continue to pursue a range of business model or store models within the business. And let's say, Pizza Hut, for the new store that we opened this year, 70 to 80% of the stores are smaller stores. We are talking about 100 square meter or 150 square meter or below. That is the smaller store we are pursuing.

When it comes to retail, new retail, it's still early days. Last year, for 2021, our sales was about, give and take, about USD 80 million. And that doubled the sales the year before because we have been incubating this business for a few years now. And as of quarter 1 this year, we further doubled compared to the previous year. So for the quarter 1, we are talking about close to USD 40 million new retail sales.

I mean when we put it in the entire business, we have a pretty big base, so we are talking about 1% to 2%. But then if we only look at the locked-down cities such as Shanghai, we can be talking about 10%, 20%; or even in smaller business, 50% for the emerging brands. So how big it is in the future is a bit too early to tell. But as I mentioned earlier, we are in a very good position to do that because we have the product, we have the store network, and we have our online channel. And we have our own logistics and delivery capability. And so for new retail business, even though it's still relatively small, it's profitable, which is very, very difficult to achieve.

So that's where we are, and it's proven to be particularly important in difficult time like this. And we are so glad for the flexibility and agility of the new retail that brought us in the middle of the pandemic. Thank you.

Hau-Yee Yan ***HSBC, Research Division - Hong Kong and China Consumer Analyst***

Thank you so much for sharing the store sales and different formats, Joey. If I observed like correctly, I actually also observed your per-store number of employees declined by around 30% in between 2021 to 2019. So if like I assume like things are back to normal one day, actually there is a hope for like a labor cost productivity gain like to show like in your financial results. I'm not sure if that's like your expectation, yes.

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

Labor productivity is an ongoing challenge. And back to 2015, 2016, we have -- 2015, we had 7,000-plus stores. We have about 420,000 or 440,000 staff. Right now, we have 12,000 stores. We still only have 420,000 staff. So that gives you a sense about it.

And then during the pandemic -- during the lockdown of Shanghai, some stores are operating at 5 to 10 people, but this is not sustainable. That means our staff really putting every ounce of their energy. But there will be some innovation coming out of this because we are pushing our thinking into sharing management head count across the store, which is something that we learned from ourselves in our deliveries, rider sharing among few stores. So some innovations will stay, but to what extent, we are still in the process. Thank you.

Operator

(Operator Instructions) Our next question will come from Xiaopo Wei at Citi.

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

Joey, my question is about the new business. I mean we appreciate the great effort in the tough time in 1Q. And we know that your sophisticated supply chain, very agile digital ability impress us again in the tough time. So you did mention in your prepared remarks about the group purchase, which is a very new model in Shanghai. Do you think this is going to be a valid model to expand into other part of China even if the COVID situation improves? That's the first question.

The second question is for the market consolidation, yearly, we are seeing the tough time like COVID situation always a good opportunity to consolidate market. We still remember that in the second quarter 2020, post the first wave of COVID, you guys are consolidating market immediately. So presumably, the casual dining segment can be more consolidated post the COVID waves than the QSR. So this is referring to like Pizza Hut, where the investors have been focused a lot. Shall we say that your Pizza Hut business could be even more -- enjoying more advantage of market consolidation post this wave of Omicron wave versus previous one? So those are the 2 questions.

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

Thank you. So for the first question, community purchasing, we...

(technical difficulty)

Operator

Unfortunately, it looks like Joey's line has dropped once again. Please stand by while we reconnect her.

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

Yes. While we connect Joey, let me address the second question, which is about the consolidation opportunities in the marketplace. I think as we have mentioned on our capital allocation strategies, obviously, we have put a lot of emphasis on investing in CapEx to drive organic growth and then also to build our strategic moat. So our presence for consolidation in the marketplace is really to the expansions of our store network across all the brands. We have the KFC, quick-service restaurant business. We also have Pizza Hut in the Western casual dining business. We also have COFFii & JOY and Lavazza in the coffee business. And then we also have the Chinese foods business. So I think we already have a number of opportunities.

As we mentioned, today, we also have a -- sort of like a new announcement -- arrangement with YUM! Brands to jointly step up investment to accelerate store network expansion here in China for Taco Bell. So I think we already have a lot of wonderful opportunities in coffee and Taco and as well as the growing opportunities here with KFC and Pizza Hut. So I think the main focus, the main driver for us for consolidating the market is really through expansion and the growth of our own organic brand.

I see like Joey is already back online.

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

Yes.

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

So Joey, will you address the first question? Yes.

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

So the community purchasing, Xiaopo, we, of course, share the best practice within the company. So we get the scenario plans for whatever cities and province. If it's going to lockdown and/or soft lockdown, we keep their options open. Right now, community purchasing in Shanghai, as the shopping becomes slightly easier, we can see the demand come down a little bit, which is a pretty good thing, actually.

But at the worst time, we have 10% to 15% stores open in Shanghai. But as of right now, we have about 40% of our stores open. So we can still serve customer better with more stores open than just relying on community purchasing. But it is sort of an example of our agility and the stability of our business model and our team. So thank you.

Operator

Our next question comes from Jack Chen at CLSA. Sorry, looks like Jack's dropped from the call. Our next question will come from Christine Peng at UBS.

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

So I have a quick question regarding the cost-cutting measures. So given this prolonged and fluid situation about COVID restrictions and lockdown in China, so I'm just wondering what kind of cost-cutting measures management has put in place or considered putting into place to deal with this situation. And also, I remember back in 2020, there are quite a few government grants given to Yum China during the COVID period. So are there any government grant similar to 2020 that will be given to Yum China for the remaining of the year?

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

Christine, so let me address your questions regarding, obviously, the cost control and cost structure. I think obviously, we're looking at from a COS side, pretty strong inflationary pressure globally. And so we will continue to work with our supply chain through our long-term supply chain partner to manage that. That will be including potentially a longer-term contract. We -- as you mentioned before, our contract usually lock in, in a quarter or 2 ahead of time. We may effectively deal with that given the inflationary pressure.

For example, for coffee bean, we have locked up supply contract that would last us to 2023, and that will help us to mitigate that. Obviously, not everything can be done like that, but I think we have very smart logistical and supply chain folks here that have a lot of experience and historically deal with different environment -- inflationary environment.

Now the other one is obviously the energy cost. Energy cost in China and globally also gone up. As we mentioned, utility price is up 10%. Then we are also implementing -- that's why we invest in technology. We have and we continue to invest in technologies that would help us to reduce energy consumption. So hopefully, that will pay off in the long term.

And the other one is we will continue to deploy technologies across our supply chain to make sure that we both have a flexible -- flexibility to deal with given potential scenarios but also make them more efficient. So I think it's paying off as we see in the current situations. We are able to very flexibly to redesign the supply chain network, the routing and using both railroad and sea freight to flexibly manage our logistic operations. Also, we see technology being employed in store operations in the back office. So the labor productivity improvement in the long run should be helped by our investment in technology.

Now all in all, obviously, is in terms of margins or cost, the biggest driver is actually sales. And so we will continue to focus on obviously in [our CRM] (adde by the company after the call) program -- digital program and then precise marketing and drive sales. And then finally, we will continue to look at our innovations in product design and how to best utilize the resources that we have. For example, whole chicken versus some of the part. So those are the sort of like the way we look at the cost base. And then also, in the longer term, obviously, we're looking at potentially restructure some of our cost base, including brand and rental relief, as you mentioned.

In 2022, in the first quarter, the government has launched some relief program for COVID. But mostly, it is addressed to small, medium enterprises. And so we will continue to work with the government if we can qualify for some of those programs. But I think for the most part, those programs are aimed at small to medium enterprises.

For rent relief, I will continue to work with the landlord not only for rental relief but also in the longer term, as you mentioned, we don't target to a particular growth number for our stores, but we would like to have a quality store open. So we would continue to work with the landlord to make sure that our rental cost structure is competitive in the long run, and that's the most important.

So thank you, Christine.

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

So I just want to make sure the previous guidance about the commodity costs and labor cost increase for 2022 will not change despite all the volatilities we have seen in the past 2 to 3 months globally.

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

Well, I think there will be some changes, but I think the biggest driver for operating margin, as I mentioned, is sales leveraging and deleveraging. Then the other part is obviously the inflationary pressures. Some of these commodity prices have been more stable. Some are in line with our expectation, but some of this is actually very -- jumping very high right now. So if you look at, for example, poultry and pork, they're relatively in line with our expectation. But if you look at beef, if you look at other commodities, they have surged quite a bit. And then also, if you look at energy, costs also go up. And so for example, cooking oil, all that is impacted. All in all, I think like as we mentioned, those are the smaller factor, but the sales deleveraging is the biggest.

Operator

Our next question comes from Bryan Wang at China Merchants Securities.

Kin Man Wang ***China Merchants Securities (HK) Co., Ltd, Research Division - Research Analyst***

Joey, so basically, I want to understand your P&L. How much of your cost of good sold and also the restaurant cost are fixed and how much is still variable. Because on your P&L, so I don't see that. The line of COS is around 30%. And I wonder that your lease contract, how much is largely based on the sale -- on the store sales.

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

Bryan, I think your line was coming in and out, but my -- I guess your question is about costs and particularly variable costs versus fixed costs. Okay. So I think as I mentioned before, obviously, the key cost structure for us in COS is largely variable cost is what it include, paper and packaging for our products. And then COL, we have a hybrid model. Obviously, we have full-time workers, and then we also have a large part-time workforce that's on a more flexible scheduling basis.

In terms of O&O, as you mentioned, the rent, a big part of a large percentage of the rent, 80% of that have a variable component to it. And in terms of dollar sign, it is probably -- depending on the sales, obviously, it is variable. So normal times, maybe 40%, 50% of that, above 50% or so at this time, it's variable for rent. And then we also have obviously marketing expenditure and all that we can flex around that.

So the overall cost structure, I think it was fair to say that majority of our costs are flexible, variable, but we also have a very large portion of them is fixed, including our G&A expenses. For example, salary for our headquarter staff, most of the operations and then the fixed cost in rental. So sales leveraging and deleveraging is real for our business and as we have mentioned over and over again.

So -- but we -- as we mentioned before, we're doing a lot of things to control costs in the near term but also looking into longer-term structure. For example, like G&A and in the short term may be impacted by sales leveraging and deleveraging. And then -- but in the long term, our goals is to keep G&A growth to be below sales growth, for example. So that's overall how we do our things. We'll use technology, then improve our process and store format, et cetera, to make sure that in the long haul, our labor productivity is in a good trend.

So thank you Bryan.

Operator

Our final question comes from Jack Chen at CLSA.

Ruofan Chen ***CLSA Limited, Research Division - Research Analyst***

My question is regarding on Taco Bell brand strategy because this brand has entered China market for years but still in small size. So as we are planning to have over 100 Taco Bell stores by this year, so could you please share us more about how we're going to develop this brand to benchmark with KFC and Pizza Hut?

And since the COVID hit several big cities in China, so if this trend continues, we want to know how it will impact our store opening such as maybe we can only find the store locations in low-tier cities and less-impacted regions.

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

Thank you, Jack. We look at this Taco Bell opportunity in -- over a very long term. If we look at, let's say, Pizza Hut, we are already in 700 cities and only in 700 city out of 2,700 cities. And KFC is in 1,700 cities. So if we in the coming few years, we want to open at least 225 stores. And honestly, it's not that...

(technical difficulty)

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

Joey has dropped off the line. So I would just comment on what Joey has been mentioning. So obviously, we have looked into the Taco Bell business for a number of years. But as Joey mentioned, we still have a lot of opportunities not only for our existing brands, KFC, Pizza Hut, but obviously for Taco Bell, too. 225 new store by 2025 is ambitious target but not an overstretching target.

If we look at the reason why we are confident about stepping it up, obviously, we have experimented with the brand quite a bit with the format, different format and whatnot. And then I think some of the pilot testing that we have earlier to make us more efficient and flexible are showing some very encouraging sign especially for the newer, smaller format, which is about 100 square meters and lower capital expenditure and with a simplified menu. I think if you look at the store performance, that give us quite a bit of encouragement in terms of expanding the store network there.

Again, like we -- obviously, it's really important for us with any store opening is the disciplined process. We do apply disciplined process with a smaller store format and a new format for Taco Bell as well. And so in terms of our Taco Bell is we -- I think we've seen that in the urban top-tier cities pretty popular with younger generations. They are more open to trying out new good food. So -- and then if you look at -- during the lockdown period, the brand also did quite well with the product offering as well as the delivery coverage. So we're excited. We're excited with the Taco initiative. Over the next few years, you should see more growth in that brand, and then we would obviously step up investment with Taco Bell international to drive that store network growth. Thank you.

Florence Lip ***Yum China Holdings, Inc. - Senior Director of IR***

Thank you for joining the call today. We look forward to speaking with you on the next earnings call. And sorry about the connection. Have a great day.

Operator

Thank you so much. This does conclude the call today. Thank you all for joining. You may now disconnect.