REFINITIV STREETEVENTS

EDITED TRANSCRIPT

Q3 2021 Yum China Holdings Inc Earnings Call

EVENT DATE/TIME: OCTOBER 28, 2021 / 12:00AM GMT

CORPORATE PARTICIPANTS

Joey Wat *Yum China Holdings, Inc. - CEO & Director*
Ka Wai Yeung *Yum China Holdings, Inc. - CFO*
Michelle Shen *Yum China Holdings, Inc. - IR Director*

CONFERENCE CALL PARTICIPANTS

Chen Luo *BofA Securities, Research Division - MD*
Kin Shun Ling *Jefferies LLC, Research Division - Equity Analyst*
Lillian Lou *Morgan Stanley, Research Division - Executive Director*
Michelle Cheng *Goldman Sachs Group, Inc., Research Division - Executive Director*
Xiaopo Wei *Citigroup Inc., Research Division - Director & Head of Asia-Pacific Consumer Research*

PRESENTATION

Operator

Good day, and thank you for standing by. Welcome to the Yum China Third Quarter 2021 Earnings Conference Call. (Operator Instructions) Please be advised that today's conference is being recorded. (Operator Instructions)

I would now like to hand the conference over to your speaker today, Michelle Shen. Thank you. Please go ahead.

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

Thank you, Lyndon. Hello, everyone, and thank you for joining Yum China's Third Quarter 2021 Earnings Conference Call. Joining us 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 presentations contain forward-looking statements, which are subject to future events and uncertainties. Our actual results may differ materially from these forward-looking statements. All forward-looking statements should be considered in conjunction with the cautionary statements in our earnings release and the risk factors included in our filings with the SEC.

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

Today's call includes 3 sections. Joey will provide an update regarding recent developments and our third quarter 2021 results. Andy will then cover the financial performance in greater detail. Finally, we will open the call to questions. You can find the webcast of this call and the PowerPoint presentation, which contains operational and financial information for the quarter, on our IR website.

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

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

Thank you, Michelle. Hello, everyone, and thank you for joining us today. As we shared in mid-September, we navigate a very challenging situation in the third quarter. The Delta variant outbreak that started in late July spread to 16 provinces. It became the most widely spread regional outbreak since the first quarter of 2020. Strict public health measures were implemented across the country. Trading was significantly impacted during the peak summer season, which is traditionally a very strong quarter for our business. Same-store sales declined by 7% in the quarter as demand fell for in dine-in, although this was partially offset by growth in delivery.

I want to take a minute to thank our 440,000 employees who are working diligently and rapidly finding solutions in this fluid situation. In response to the sharp decline in dine-in traffic, we quickly adjusted marketing campaigns, operations and supply chain to drive demand for off-premise. Delivery sales grew 23% year-over-year or 62% on a 2-year basis and contribute approximately 34% of sales in the third quarter.

New retail business grew rapidly with sales in the third quarter almost equal to the first 2 quarters combined. Our ability to engage customers digitally was essential during this difficult time. In the third quarter, over 60% of system sales came from members. We add about another 20 million members, ending the period with a total member count of over 350 million. We sold 19 million Privilege subscriptions, including the popular KFC chicken lovers card, [Wang Zha Ka], which is a summer exclusive.

Having taken important initiatives to drive sales, we saw a sequential recovery in September. For the quarter, system sales growth was positive compared to last year and to pre-COVID. New unit growth more than offset the same-store sales decline. We broke record by opening 524 new stores, ending the quarter with 11,415 stores. However, we do not compromise quality for quantity. We have prudent new store approval process and carefully track the performance of each new store. New store payback remains healthy at around 2 years at KFC and 3 years at Pizza Hut. Our smaller store formats enable us to increase store density in higher-tier cities and further penetrate into lower-tier cities with lower CapEx and rent.

Let me provide some color on our key brands. First, KFC. We stepped up value and promotional campaigns to drive traffic, and we introduced great food items. Juicy whole chicken was sold out within a week. Our meat sauce Wagyu or Angus beef burger also proved popular. Our premium beef burgers have been very successful since becoming permanent menu items. We are building a beef burger platform covering different price points.

We're taking menu innovation and localization to the next level. Following the success of hot dry noodles, Reganmian, in Wuhan, we rolled that out nationwide in September. In a week of launching, we sold over 1 million bowls. It's the best-performing limited time offer breakfast item in the past 3 years. We also introduced steamed dumplings, xiao long bao, to more stores in Eastern China. More recently, we launched hot pepper soup, the very famous Hulatang, in Henan. All of these are very well received by our customers. KFC has added nearly 1,000 stores and entered 150 new cities over the past 12 months. As we mentioned during the Investor Day, we are now tracking 1,200 potential cities that we could enter in the future with multiple store formats.

Next, let's talk about Pizza Hut. Years of transformation has proved -- has improved Pizza Hut's fundamentals and resiliency. In the third quarter, Pizza Hut opened 103 stores, the highest number of store openings in a quarter since 2016. Satellite stores and other smaller formats accounted for over 70% of the new stores and enabled us to capture the strong demand for delivery with higher store density.

We upgrade our buy one, get one pizza promotion. For the free second pizza, customers were given more flexibility to choose when, where and what pizza they would like to have. This mechanism was a breakthrough for us, enabled by our upgrade digital platform. The promotion was exciting for customers and create sales uplift for us. During this 10-day campaign, we sold approximately 1 million buy one, get one pizza [sets]. For a limited time, we also offered new pizza flavors modeled on popular Chinese dishes such as sea bass pizza with pickled vegetables, Suan Cai Hai Lu Yu, and spicy stir-fried hot pizza, Ma La Xiang Guo. These innovative products were Pizza Hut's take on localization and position us to attract young consumers who love to try new things.

Moving on to coffee, our third growth engine. We are very excited about our deepened partnership with Lavazza. This 126-years-old Italian brand offers a truly authentic Italian experience. Our Italian coffee exclusively uses high-quality Lavazza beans roasted in Torino, Italy. In addition to coffee, customers love their delicious food, popular item like Emiliano, which is toasted sandwich, and mini croissant with ham and cheese and made fresh in our fully equipped kitchen. The high proportion of food, which is 25%, contributes to higher ticket average.

At the end of September, we had 26 Lavazza stores in 4 top-tier cities. We expanded beyond Shanghai to Hangzhou, Beijing and Guangzhou, where our stores received great customer feedback. Our first Beijing store is already ranked the most popular café in Chaoyang District. Encouraged by the positive results, we expect to enter into more top-tier cities and more than double our current store base in the fourth quarter.

Despite recent challenges, our commitment to China's long-term growth remains unshaken. We are always planning for the future and have been executing on the strategies outlined during our September Investor Day. Despite the difficulties posed by the outbreak, we worked diligently to build our store pipeline. We now expect to open over 1,700 gross new stores in 2021, up from 1,300. I'm also excited about our investment in Hangzhou Catering Service Group. This will allow us to accelerate growth across our brands in Zhejiang province.

Lastly, we continue to enhance capabilities in supply chain and digital. These are stores -- these are our core enablers for sustainable growth in the long term. Last week, we opened our digital R&D center with 3 sites in Shanghai, Nanjing and Xi'an. The center is a key part of our strategy to build a dynamic digital ecosystem. The R&D center will consolidate and expand dedicated resources to develop solutions and services to optimize customer experience and operating efficiency. We plan to invest $100 million to $200 million and to employ up to 500 staff over the next 5 years for this particular initiative.

As for supply chain, in addition to the logistics center in Chengdu, we have another one under construction in Huai'an, which is in Jiangsu province. There are also several sites in the pipeline. As we mentioned during the Investor Day, we plan to operate about 45 to 50 logistics centers and consolidation centers over the next several years to support our expansion and to further increase efficiency.

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

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

Thank you, Joey, and hello, everyone. Let me first review our third quarter financial performance and then discuss this year's outlook. Unless noted otherwise, all percentage changes are before the effects of foreign exchange.

Let me first cover the third quarter performance. Actual results are in line with the business update that we released in mid-September. Third quarter performance was disrupted by the Delta variant outbreak, resulting in same-store sales declines of 7% year-over-year. However, we still delivered positive revenue growth and system sales growth, which is led by new unit contribution. Total revenues grew 2% year-over-year and reached $2.55 billion. System sales increased 1%.

Similar to prior quarters, we are providing pro forma measures here for convenient comparison with 2019. Same-store sales were approximately 87% of the third quarter 2019 level. KFC's same-store sales were approximately 92% of the last year level and 87% of the 2019 level with same-store traffic at approximately 82% of 2019 level. Average ticket grew roughly 6% versus 2019, mainly due to the increase in delivery mix. Pizza Hut's same-store sales were approximately 95% of last year and 89% of 2019 level. Same-store traffic is on par with the 2019 level, while average ticket decreased by about 10%, driven by the increased mix in off-premise occasions, which have a lower ticket than dine-in.

KFC was likely more affected than Pizza Hut again this quarter as KFC has a higher store mix in transportation and tourist locations. These locations experienced a sharp decline in sales and approximately 40% on a 2-year basis in the quarter.

Restaurant margin was 12.2%, down 640 basis points compared to last year. This was mainly caused by sales deleveraging, more value promotions, higher wages and increased delivery costs associated with more delivery orders as well as lower COVID-related relief this year. Cost of sales was 32.2%, 100 basis points higher than last year. Modest decline in commodity prices year-over-year partially offset the step-up value promotions to drive customer traffic and phasing out of plastic packaging and other packaging upgrades.

Cost of labor was 25.6%, 400 basis points higher than last year. This is due to a few factors. First, wage inflation was 6% in the quarter, notably higher than the previous quarters. Second, increased delivery volume contributed to higher labor cost percentages. Third, additional labor hours were scheduled going into the third quarter, which is typically a seasonally strong trading period for us. We also scheduled more labor hours for increased safety protocol during the outbreak. We were quick to adjust labor scheduling and mitigate the sales leverage and impact.

Occupancy and other was 30%, 140 basis points higher than last year, mainly attributable to the sales deleveraging impact. In addition, we received $10 million COVID-related onetime relief in the third quarter last year, while the amount was only $2 million this year.

G&A expenses increased 6% year-over-year, mainly due to higher compensation costs and increased head count. We remained profitable in the quarter with operating profit of USD 178 million. Excluding a noncash remeasurement gain of our existing equity interest in Lavazza joint venture of $10 million, adjusted operating profit was $168 million, a 52% decrease year-over-year or a 48% decrease compared to 2019.

Our effective tax rate is 28.3%. We maintained the full year effective tax rate outlook at 27% to 29%. Net income was $104 million, and adjusted net income was $96 million. Excluding $32 million net investment loss of Meituan, it was $128 million, down 50% year-over-year. Diluted EPS was $0.24. Mark-to-market loss in Meituan negatively impacted our diluted EPS by $0.07. In the quarter, we returned $85 million to shareholders in the form of cash dividends and share repurchases.

As we look ahead to the fourth quarter, we remain cautious. Strict public health measures are still in effect. Consumer are cautious about spending and are traveling less. According to government statistics, for the 7-day National Day holiday starting October 1, the number of traveler was down 2% compared to the same period last year and down 30% versus 2019. Related travel spending was down 40% compared to 2019. While we are seeing a slight sequential recovery in same-store sales, they still remain below prior year and pre-COVID 2019 level, as overall dine-in volume and traffic and transportation hub are still significantly impacted. We expect the recovery of same-store sales to take time with a nonlinear and uneven path.

Recently, we have seen a resurgence of cases across 12 provinces and municipalities, including Inner Mongolia, Jiangsu and Beijing. We will continue to monitor the development and stay agile. In addition, the fourth quarter is seasonally the smallest quarter for sales and profit margin.

Based on what we are seeing so far, we expect the margin and operating profits in the fourth quarter to be significantly impacted by: One, sales deleveraging as same-store sales remained below the prior year and pre-COVID levels.

Rising commodity prices. Since the fourth quarter of 2020, we have benefited from a deflationary environment, which will very likely end in the fourth quarter. Cost of sales will also be pressured by aggressive campaigns as we will continue to drive traffic through attractive promotions.

Three, wage inflation, which is expected to be in the mid-single-digit range. Rider costs are likely to continue to increase as delivery trends further upward.

Please note that the fourth quarter last year include several onetime items, including: One, COVID and other onetime relief from government and landlords, almost $13 million; two, lower staffing level due to shortage of part-time workers. These are unlikely to repeat this year.

Now despite the near-term challenges, we remain committed to driving long-term growth. In the short term, we will focus on keeping our operations agile and resilient in the face of considerable disruption and uncertainty caused by the pandemic. For the long run, we will focus on fortifying our competitive moat and growing our business and making continuous improvements in our business model and store operations. We have a strong track record of managing our cost structure and growing our business profitably over the years. We will continue to focus on product innovation and leveraging the strength in our supply chain to mitigate the impact of commodity price swings.

On the COL front, we will continue to invest in technology, automation and digital infrastructure to improve labor productivity. On the other hand, the near-term challenges, while tough for the restaurant industry as a whole, also create favorable conditions for us to expand our store network and capture growth opportunities. As Joey mentioned, we now expect to open 1,700 new units in 2021, almost 5 stores per day. We are maintaining our previous capital expenditure target of $700 million to $800 million, which benefited from our ongoing efforts to reduce CapEx spending per new store.

Looking ahead, we will continue to invest in accelerating growth and fortifying our resiliency as outlined at the Investor Day in September. We will provide you details on 2022 targets during our fourth quarter earnings release in early 2022.

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

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

Thanks, Andy. We will now open the call for questions. (Operator Instructions) Lyndon, please start the Q&A.

QUESTIONS AND ANSWERS

Operator

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

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

My question is about the commodity cost inflation. So we hear many companies are starting to talk about price hike recently. So understanding the consumption sentiment is still very challenging, so can you share with us your pricing strategy? And also, compared with the previous chicken/coffee inflation cycle back in '18, '19, when we managed the margin pretty well, so what could be the difference now versus the past experience?

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

Michelle, thank you for your questions. Regarding pricing, we have a long-term pricing strategy here at Yum China. We want to provide good food at good value for our consumers. And so over the years, we always have been very cautious about price increase. We do pass through partial inflation to the consumer. But mostly, we will try to find efficiency in our operations to offset those inflationary pressures

Now if you look back in the last few years, obviously, there's commodity price fluctuations, right? Sometimes they go up, sometimes they come down. And then over the years, in China, we always have seen labor inflation, right? So labor inflation generally is in the mid-single-digit to high single-digit range. And I think sometimes when there's a sudden surge or disruptions in the market, then you do see the impact on our margins. For this quarter, for example, the biggest impact obviously is our sales, right, because of COVID outbreak. And so you have a deleveraging impact, which is disproportionately impacting the margin.

And then -- so if you think about commodity prices, over time, we will have new product innovation, how to make use of our material better. We would also have diversifying the different cooking, right? So we have chicken now. We have beef. We have done a variety of fish and other seafood. So that also helps us to balance the commodity price increase over time.

And then obviously, we have a very strong supply chain. We always work with our supplier closely. We try to mitigate some of this pricing fluctuation. We generally place our order or sign a contract a quarter or 2 ahead of the quarter so that we know how to manage that cost increase over time. And then we also work with our supplier, obviously. In good time, the prices go up, they just have to earn a little less. And when time is bad, we also have to try to support them. So over time, we have a stable supply chain situation for them and for us as well. So that's generally how we deal with it.

And in terms of labor inflations, over the year, you have seen that we have invested quite a bit in digital automation and technology in our infrastructure. Overall, it's trying to improve labor productivity. As we have outlined in the Investor Day, you have seen Leila presented how technology help us like improve labor productivity. So a few years ago, we have 400,000-plus employees. Today, we have a similar number of employees, but we have a significantly higher number of stores. So our labor productivity has improved.

So if you look at our restaurant margin, it has remained markedly stable, right? So I think in 2016, it was roughly in the 15% range. And then in 2019, it was about 16%. And then last year, it was about 15%. So all in all, over time, we are able to manage all these different cost structure very well and maintain the margin. Thank you.

Operator

Your next question comes from Lillian Lou from Morgan Stanley.

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

My question is more on the CapEx plan because we definitely increased the gross new opening quite a lot versus the previous guidance but maintained the CapEx overall. So maybe a little more detail. I know the company talked of this for some time in terms of the unit

CapEx per store with this small format model. But can you share with us a little more about details of what have you been doing in the recent quarters in terms of the unit CapEx and the unit economics versus before that caused us maintaining the similar CapEx but with much more count of stores?

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

Thank you, Lillian. So obviously, this quarter, we did set up our CapEx budget. For the whole year, we already -- it's probably higher than last year. We -- I think our CapEx year-to-date is about $480 million.

So obviously, as we have outlined in our capital expenditure plans in our Investor Day, investment for CapEx is to drive organic growth and obviously build the competitive moat. So that's most of the components to it. So one is obviously that stores that we are opening, and we are accelerating that. And as we have mentioned before, over the past few years, we have reduced the CapEx per store upfront investment. So if you think about a few years back, our CapEx per store was about RMB 3.5 million. And now, it's under RMB 3 million, close to RMB 2.5 million.

There's 2 drivers for that, right? One is obviously the size of the store changed. The other one is overall per square footage cost reduction. And so our team worked very hard. Our development team and our brand team worked very hard to do that to make it more efficient. So I think with our new smaller store format, for example, Pizza Hut, KFC, small town models and more small store format catering to our delivery and takeaway, I think we still have some opportunity to further reduce CapEx per store going forward.

Also, the other component obviously is remodeling. I think that, over time, will continue to trend up just because we have a bigger portfolio of stores. And then the third part is investment in supply chain and infrastructure as we have outlined before in Investor Day is to drive efficiencies and resiliency in our supply chain. It's to drive labor cost improvement through investment in technology and digitalization and et cetera. And so I don't think there's a material change to our plan. So hopefully, we can give you more updates next quarter in terms of our full year CapEx spend. Thank you, Lillian.

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

I'll just add a few comments on this one, Lillian. For today, we update the new store guidance for the year from last quarter's 1,300 stores to 1,700 stores for the year, but we did not increase the CapEx spend for the year. It will stay at $700 million to $800 million range. So what happened here? What happened here, obviously, as you guys know us quite well, we don't chase after a blind store number. We open good quality stores. If we can find a good quality store with additional profit and sales, then we will open it.

So in terms of store economics here, I would like to give you three comments. One is the smaller stores are driven by increased off-premise mix, in that it means the delivery and takeaway. So the smaller stores help that business, and the smaller stores help us increase the store density in the top-tier city, in particular. So these are the Pizza Hut satellite stores, the KFC smaller stores. And also, these stores with the lower investment and incremental sales and profit, it helps penetrate into the smaller cities because we have a variety of different business models for different locations.

So number two comment, it's normal that these smaller stores have smaller sales per unit. But as I mentioned earlier, they drive incremental sales and profit and they demand less CapEx per store, as Andy mentioned earlier.

Third is that payback is healthy. So you know the KFC payback is always about 2 years. And Pizza Hut, right now, if you noticed what I said earlier is Pizza Hut, the store payback is at 3 years now in total. That is an improvement because in the past, we always conclude that the payback of Pizza Hut takes about 3 to 4 years. So now it has improved to 3 years because the smaller stores, the Pizza Hut satellite store right now, their payback is at 2 to 3 years. So in total, the improvement is at 3 years.

So I hope that gives you a sense about why we are increasing the new store guidance for the year because if we look at our system sales growth number, it also tells the story for the entire Yum China versus 2020, we are driving 15% year-to-date system sales growth. And that includes 12% year-to-date system sales growth for KFC and 20% system sales growth year-to-date for Pizza Hut. And then for KFC, even compared to 2019, for year-to-date, we are also achieving 4% system sales growth despite all the challenges of the outbreak and/or the same-store sales.

So let me conclude the question here. Thank you, Lillian.

Operator

Your next question comes from Mr. Xiaopo Wei from Citi.

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

Joey and Andy, I have a very brief question on your acquisition. In the press release this morning, you mentioned that you acquired 28% stake in Hangzhou Catering Services, which are operating a few great local Chinese brands. My question is, were you opening some stores on a stand-alone basis under those brand, pursuant to any arrangement with the Hangzhou Catering company? Or you are more looking at bringing those greater local cuisine, like a Zhi Wei Guan and et cetera, to your existing KFC stores or Pizza Hut to diversify our portfolio, to build more great local food to the Chinese consumers? So any color would be highly appreciated.

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

Thank you, Xiaopo. So we have been working with Hangzhou Catering for a few decades now. This is our joint venture partner of Hangzhou KFC stores, and Hangzhou market is one of our best markets in terms of sales and profit. And we are very grateful that we have the opportunity to invest 28% into the Hangzhou Catering. And that enabled us to achieve consolidation of Hangzhou KFC business, which is about 700 stores with very nice expansion opportunity ahead. So that's point one. The point two is while Hangzhou Catering has other business such as Zhi Wei Guan and Kui Yuan Guan, et cetera, our focus is still on our KFC business.

In terms of future cooperation, we do see cooperation in 2 areas. One is working with them on their central kitchen or factory, whatever you call it. They have very high-quality facilities. And actually, we did already work with them. Our xiao long bao launched in Hangzhou market Zhi Wei Guan xiao long bao. Guess what? They were produced by the central kitchen or the factory of Hangzhou Catering.

The second area we see we are going to further expand our cooperation is store opening because another key shareholder of Hangzhou Catering is a very successful and important player in the commercial properties in Zhejiang province. And we already worked with them to open our first and the most important flagship store for Lavazza in Hangzhou. So these are the 2 areas that we certainly will see us accelerate our cooperation on top of KFC store expansion in Zhejiang province and particularly Hangzhou.

Operator

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

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

Joey and Andy, my question is on the margin side. Our Q3 restaurant margin saw over 6% year-on-year decline. I understand that it has been negatively impacted by the COVID outbreak in the quarter. However, if we looked at Q2 and Q3 last year, we had a similar or even higher same-store growth decline, but our margin trends were better back then. I'm just curious to get more color on the different dynamics behind. In particular, our labor cost ratio was up 4% year-on-year, which was higher than the net ratio of labor cost increase in Q1 last year, which was the worst time of the COVID outbreak. Apart from the wage inflation and sales deleverage, can you actually elaborate a bit more on other reasons for us to better understand the dynamics behind the labor cost increase?

In addition, our occupancy and other cost ratio has also increased. Normally, in normal times, it is always trending down and serves as a big driver to our [stronger] (corrected by company after the call) margins. So do we still see further room of cost savings on this line item in the future, barring extraordinary situations like in Q3 this time?

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

Thank you, Chen Luo, for your question. Let me try to address the questions here. First of all, I think before we go into each underlying item, I want to really emphasize that sales deleveraging is real. We're running a restaurant business. So when sales come down, it would have an impact on our labor costs and on our O&O. So I don't want any misunderstanding. We have done very well over the last couple of years, and last year was also some special situation, obviously.

So let me address that here on, for example, on the cost of labor on the sales dynamic. If you look back in, for example, in 2020, as we have mentioned at that time, we had a very strong sales trading going into the Chinese New Year period in 2020. And the period before Chinese New Year and during Chinese New Year normally is a very important, very good trading season for us for both in terms of sales and profitability. So we have a benefit at that time for that first month, okay? So because if you recall, the outbreak was right around the Chinese New Year. So there's a timing difference.

This quarter, for example, in the third quarter, the outbreak happened and impacted the full quarter at the beginning to the end. So we have this full quarter impact in the sales trading situation there. So that's why when you have a very profitable quarter, for example, especially for us, which is July and August time period before kids go back to school, that sales trading would have an impact on sales deleverage.

The other one is commodity prices, obviously. This year, we have a couple of things that is going to impact us. One is, as we have mentioned before, we're phasing out plastic in our packaging. We have mentioned that last year. That's going to have an impact on us. And then when we look at the other parts of revenue, obviously, we have all this infrastructure to deliver product to our restaurants. So when sales deleveraging happens, it's going to impact the cost per package, for example, that they will deliver to restaurants.

And then if you look at labor, for example, labor, this year, as we have mentioned in last quarter, we raised our staff wage in June and July. That's after sort of like holding it back and trying to control the cost for the first half of this year. At that time, our labor inflation was about 2% to 3%. In the third quarter, it's about 6% to 7% increase. So it's higher.

And then another thing that is very important to notice as I mentioned on our prepared remark, third quarter is a big trading season. So we have planned some of the labor scheduling ahead of time. The other part is that during the outbreak, we also had to step up staffing to make sure that we followed tightening health protocol. So you measure temperature. You check if you have a cold. You do more frequent, table cleaning et cetera, et cetera. So that's then the COL impact there.

And then in terms of O&O, obviously we have some variable cost. Like whenever you open a restaurant, you will have utility cost. You will have some rent. Rent -- some of it is fixed, and some of it is variable. So again, you're going back to that sales deleveraging impact on the margin.

I think in the longer run, I think we have been able to manage the cost structure quite well. We have seen, obviously, as I mentioned before, commodity price fluctuations, labor cost increase. Again, going back to what we do best, we're working with our team, our food innovation team to introduce good products at great value for consumer. One example that we have recently done is we have a fried chicken bone as a snack.

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

Shengyang Jijia.

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

So that's a good way to utilize obviously part of the chicken that we have not used previously. We also used that for, for example, soup, right? So product innovation is very important for us, and we'll continue to do that.

Working with supply chain is very important. I think a couple of years ago, when prices, again, were surging or coming down, we have mentioned consistently to people that we will work with our supplier for the long term. So we help each other in good time and bad time. And so in that case, it will help us to sort of mitigate, not completely eliminate, the impacts that we will try to mitigate. So we'll continue to do that, working with our supply chain on COS.

And COL obviously is very important. You notice that. Delivery costs, volume go up in pandemic, it's going to have an impact on COL. But we're able to manage that long term. But sometimes some of the shorter-term change in the delivery and dine-in mix would also have an impact. So again, we're going to invest in technology, infrastructure, automation, including investment in our infrastructure in delivery and make it more efficient, right? The food production, queuing for food productions, the route optimization for our rider, how we design the trade zone and all that, so we're trying to continue to make the operation more efficient.

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

And I also look forward to having a try on Shengyang Jijia when I'm in China next time. Is it nationwide or just offered in Northeastern China?

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

And many other products, Hula Tang, Reganmian, all of these are fantastic.

Operator

Your next question comes from Anne Ling from Jefferies.

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

I also have questions regarding your acquisition of the Hangzhou Catering group. Does it mean that you're now owning 73% of the company? So meaning that, moving forward, you will consolidate that 700 stores in terms of sales and operating profit, and then you take out your minority at the minority line? So if this is the case, number one is that, would there be any exceptional gain on the revaluation of your KFC investment or subsidiaries in the 4Q?

Second question is like how should we be expecting in terms of the sales and/or the operating profit impact? In Hangzhou, their sales per store possibly will be higher. What will be the profitability impact like?

And a minor question is regarding, if it is probably an associate, then I'm not sure my calculation is correct. It seems that third quarter, it was a loss of $6 million. So I'm not sure whether it is related to the Hangzhou business or it is something else?

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

Sorry, Anne Ling. The last part, I didn't get it. Like what was the $6 million related to?

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

The $6 million loss is the associated to the equity contribution below the operating profit line. So is the equity contribution from your investment. It's in the cash flow.

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

Okay. So I didn't quite understand the question, so we may have to take that question offline. But I will try to address the first question. I think, first of all, like we did not acquire Hangzhou Catering. We invested 28% in Hangzhou Catering. So we have a 28% stake in that company, not acquisition of that company. The other part is because of some of other corporate governance arrangements, so now we actually have basically control of the Hangzhou JV. And so now we will consolidate that. And you're correct, similar to prior consolidation of our JV at Wuxi and Suzhou, generally, we would have a remeasurement gain because obviously, those are very successful JV, right? It's kind of complicated accounting. It's related to business combination, right?

So under U.S. GAAP, even though you only acquire a portion of the stake, you generally treat it as a combination of business. And then you treat it as a whole, what's the gain of your entire consolidation, your portion of that. So it's not just a proportion to the interest that you acquire but the overall company. And so that's why normally, you see this disproportionate remeasurement gain. And then eventually, it will flow into the balance sheet because, obviously, it's based on the acquisition or combination of allocations. And so generally, you would see an increase in goodwill as well as intangible. That process is similar to our treatment of that in Suzhou and Wuxi, okay?

If you want more detail, I will refer you to our filing, the 10-Q and the 10-K statements. It will have more detailed explanation and technical explanation of the kind of treatment of such a combination.

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

Anne, just to be very clear, we have originally a minority control of our Hangzhou joint venture of KFC. With the additional 28% investment into Hangzhou Catering, Yum China will control and consolidate our Hangzhou KFC with approximately 60% equity interest directly and indirectly.

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

That's right. In term of the impact, obviously, it would not impact the system sales. It would probably increase company sales. But in term of the profitability or will that increase that, we're still assessing it because as we mentioned, there will be some amortization coming from this and then also the remeasurement of the franchise right. There's a lot of complications, but we're still assessing it. But it will be similar to, as we mentioned, to the accounting impact of Suzhou and Wuxi, right? But in term of profit, it is not as straightforward whether it will be immediately accretive or dilutive.

Operator

Presenters, there are no further questions at this time.

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

Thank you for joining the call today, and we look forward to speaking with you on the next earnings call. Have a great day.

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

Thank you all.

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

Thank you, everyone.