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YUMC - Q1 2017 Yum China Holdings Inc Earnings Call

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by and welcome to the Yum China first quarter 2017 earnings results conference call. (Operator Instructions) I'd now like to hand the conference over to your first speaker today, VP of Finance and Investor Relations, Ms. Christie Ju. Thank you. Please go ahead.

Christie Ju - Yum China Holdings Inc

Thank you, Tara. Good morning and good evening, everyone. Welcome to Yum China first quarter 2017 earnings call. A live broadcast of this call and a PowerPoint presentation are available through our website under the events and presentations section. Joining me today are our CEO, Micky Pant; our President and COO, Joey Wat, and our CFO, Ted Stedem. We will start with opening remarks from Micky, Joey and Ted, and then open the floor for Q&A.

Please note 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 factor included in our filings with the SEC.

Let's move to agenda page on slide 3 please. Micky will start with first quarter 2017 highlights. Joey will discuss brand performance and Ted will discuss our financial results. After that, we will open the floor for Q&A. Now let me turn the call over to Mr. Micky Pant, CEO of Yum China.

Micky Pant - Yum China Holdings Inc

Thank you, Christie, and thank you to everyone for joining our first-quarter 2017 earnings call. Before I get to the highlights of our performance, I wish to draw your attention to slide number 4 and point out that 2017 is a very significant year for our Company. We all know that this marks the first full year of operations since our public listing. Less known is that this year we also celebrate the 30th anniversary of our first KFC store in Beijing. And lastly, the quarter was notable because last year we had a very successful Chinese New Year promotion in the first quarter and we were lapping some daunting numbers.



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While we have three quarters remaining in the year and each quarter has its own opportunities and challenges, we are pleased with the start of the first quarter. We were very pleased to record positive same-store sales growth for the Company and for each of our two major brands, that is KFC and Pizza Hut Casual Dining. We also built new units at a very healthy rate. And while growing our sales on new units we also significantly improved our margins, profitability and cash position. Overall, therefore, we are facing the future with increasing confidence.

Now let me give you some highlights of the quarter on slide number 5. Thanks to successful marketing campaigns, we achieved a same-store sales growth of 1%. This was impressive given that 2016 first-quarter was plus 6%. In particular, the performance of KFC is notable because it successfully lapped a plus 12% same-store sales growth in 2016 first-quarter with a plus 1%.

We continue to strengthen our presence in China and improve the quality of our stores with 133 new restaurant builds and 32 remodels. We have over 7600 units at the end of the first quarter, and we are confident that we will be able to achieve our target of 550 to 600 new stores for the year -- that's 550 to 600 new stores for the year. And last but not least, delivery and digital continue to drive topline and bottom-line growth.

A network of over 4400 restaurants in our system offer delivery services and we believe we have established an infrastructure for continued growth. In the first quarter of 2017, delivery represented about 12% of our Company's sales. On digital, with approximately 93 million loyalty program members between KFC and Pizza Hut, we believe we have unprecedented insights into consumer behavior and have been engaging with consumers across the digital ecosystem from pre-order to payment and I'll give you some more details in a couple of minutes.

Let's move to slide number 6. As you can see, our same-store sales grew 1% and our system sales increased 4% year on year for the first quarter on a constant currency basis. Both system sales and same-store sales had a solid start to the year, and you'll get more details in the brand this session. Looking forward, as I said, we are facing the future with increased confidence. We expect to face many exciting opportunities and also challenges in the marketplace, but we will continue to focus on our core business and our key strategic initiatives to drive system sales and same-store sales growth.

On slide 7, covering margin and profit. Benefiting from the impact of retail tax reform, efficiency gains and solid sales growth, our restaurant margin in the first quarter of 2017 expanded to 23%, the highest in the past three years. And also as you can see, our operating profit continued to improve sequentially year-on-year. Ted Stedem, our CFO, will provide you more details of this later.

Moving on to slide 8, let me give you some highlights of our industry-leading loyalty membership program. From a base of about 10 million members at KFC and Pizza Hut in early 2016, we have built our loyalty program to over 90 million at the end of the first quarter 2017. KFC alone had 70 million loyalty program members. In 2017, our priority is now moving from growing the number of members to also serving them better. We are gaining unprecedented insights into consumer behavior and are able to connect with consumers in all aspects of their journey.

At KFC, this includes pre-order, even before they come to the store, coupons and promotions, loyalty rewards, cashless payment and, lastly, feedback on their experience. This feedback is providing rich information on how to improve our products and service. We view our membership program as a very important asset and we believe there are opportunities to utilize it to improve customer satisfaction and to drive same-store sales growth.

To conclude my opening comments I'd like to take you to slide number 9 and give you an example. In this example, we wish to highlight the power of the customer based database that I referred to. As mentioned, 2017 is KFC's 30th anniversary in China and our team came up with this promotion which showcased how we honor our legacy with Chinese consumers.

The promotion offered our loyalty members the opportunity to buy two products, those two being Original Recipe Chicken and Mashed Potatoes and Gravy, at the same prices at which they were launched back in 1987. We delivered about 150 million electronic coupons to our members with which they can buy a piece of chicken for RMB2.5 and mashed potatoes and gravy for just RMB0.8, the exact prices at which they were first launched in 1987. The program generated a huge buzz on social media with 70 million views on Weibo within a week of launch. On WeChat, an advertorial of the promotion had over 10 million hits in a week.



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As you can see from the slide, there is a quotation typical of many consumers who posted. This particular consumer remembers a time when they went first to a KFC and said that "it has been over 30 years, my dad has passed away. And now it's my turn to take my little boy to KFC, he absolutely loves the delicious Original Recipe Chicken!

This promotion has just kicked off our year-long "Back to 1987" promotion, and we expect to generate excitement with our customers. This is a great way to make a nostalgic connection with consumers across China, many of whom cherish the memory of their first visit to a KFC. Even though this is just one example, it showcases the massive power of our loyalty membership program and, more importantly, the strong emotional bond that we share with our customers.

So that is one example. I'll leave much more detail on the brands to Joey Wat, who is the President and Chief Operating Officer for Yum China. She will share with you more detail starting with KFC. Joey, it's over to you.

Joey Wat - Yum China Holdings Inc

Thanks, Micky. Greetings, everyone. Now let me provide a quick summary of the performance of KFC and Pizza Hut Casual Dining in the first quarter 2017. Let's start with KFC. Slide 11 covers the key highlights of KFC in the quarter. KFC delivered plus 1% same-store sales growth, lapping a very strong first-quarter 2016 and system sales were up 3% year on year. In this quarter, we built 72 new stores and remodeled a further 25 stores.

Our financial performance was equally strong. We grew operating profits and expanded restaurant margins and Ted will cover the numbers in more details later. Let's take a look at the same-store sales and system sales growth at KFC. As you can see on slide 12, first-quarter 2016 was a strong quarter for KFC with 12% same-store sales growth and 16% system sales growth. It was a very tough lap and with the hard work of our team, KFC delivered a strong plus 1% in the same-store sales growth and 3% in system sales as I mentioned earlier. After a good start of the year, we'll continue to focus on driving the same-store sales growth and improve the profitability.

The strong sales were driven by our innovative products, excellent marketing campaigns and impressive store operations, not only during the Chinese New Year but also before and after the CNY holidays. Let me highlight three points on slide 13. First, strong product portfolio. We always provide our customers with new flavors and additional choices for holidays. So for the past CNY, our key products were the holiday bucket meal, "teng jiao ji tui bao" or Sichuan Chili Pepper Chicken Burger, and Roasted Wing in Peking Duck style.

Second, effective marketing campaigns with resonating themes. For example, we worked with the Chinese National Women's Volleyball team to drive a strong "wen ji qi wu", or "the Power of Start-up" campaign. The Women's Volleyball team is the most beloved sports team in China. Not only did they win a gold medal in the 2016 Olympics, they are also well respected for their hard work, dedication and positive attitude facing adversity for a few decades. The specific marketing campaign connects very well with our customers and employees and this is just one of the themes that we promoted in the Chinese New Year window.

Lastly, local customer interactions. For the first time we systematically launched a national program to honor Chinese tradition and local art in our stores. And in more than 100 KFC stores, we have introduced 21 Chinese arts and crafts to children with the help of Chinese artists in their areas..

Let's move to slide 14. Thanks to the digital ecosystem we have created at KFC, we are getting to know our customers in a more personal way. The location based mobile pre-order function enables customers to order even before they walk to our store. We also provide better in-store experience with multiple ordering methods, convenient mobile payments and easy pickup. In particular, mobile payment is right now about 30% of Company sales in the first quarter of 2017. The enrollment of our KFC loyalty members reached about 70 million. With this huge base of loyalty customers, we are able to provide more targeted promotion service to our customers. For example, Monday and Tuesday historically are the relatively slow days in a week. Since we launched our Member's Day program on Tuesday, we have seen encouraging response.

Next, page 15 is about delivery. KFC is the number one online restaurant operator in China in terms of sales, and is the single largest delivery brand in China. We have our own proprietary platform, and also we collaborate with all major third-party aggregators to drive traffic. Importantly, KFC delivers all orders and a dedicated KFC rider interacts with customers directly, and we own the customer database. We charge a delivery fee of RMB9 per order. Thanks to the growth from our proprietary platform and third-party aggregators. Our delivery sales increased over 40% in first



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quarter. Delivery accounted for about 11% of company sales for KFC. Our delivery business is profitable and we believe we are well-positioned to leverage our unique dual-engine growth model to drive sales going forward.

Now let's move on to Pizza Hut Casual Dining on slide 16. On the back of a solid marketing campaign and a lot of hard work from our operations team, Pizza Hut Casual Dining also delivered a strong set of results with same-store sales growth plus 2%, system sales grew 9% on constant currency basis. During the quarter, we also built 30 new restaurants.

On the profitability front, Pizza Hut Casual Dining significantly improved restaurant margin and delivered robust operating profit growth. In the first quarter of 2017, as you can see on page 17, Pizza Hut delivered same-store sales growth of plus 2%. It's a modest 2% but it's the first positive same-store sales growth in the past 10 quarters. We believe Pizza Hut is a powerful brand in China with a national footprint and strong brand equity. While we are pleased to see the encouraging number, we must acknowledge it was lapping a low base of minus 12% in first quarter 2016.

The 9% system sales growth on constant currency basis was also lapping a negative 1% in the same period last year. Despite the challenges ahead, we are encouraged to see the performance in the start of the year. It's our priority to sustain the positive momentum and to continue driving the same-store sales and profitability. Let's turn to slide 18.

I would like to highlight what worked to drive sales recovery at Pizza Hut. This year, our Chinese New Year menu includes a new Chicken Pizza to celebrate the Year of the Rooster. This, combined with our quite interesting tailor-made monopoly game, offered a seasonal greeting to our customer for the New Year. The national launch of Durian Pizza was helpful to enhance our image as the pizza expert.

In addition, our digital marketing program also contributed. For example, we launched a birthday privilege program in January which offered discount to our loyalty members who were celebrating their birthdays in the month. Our analysis confirm a meaningful pickup in incremental customer visits and sales, which was very encouraging.

Slide 19, let me provide an update on digital and delivery at Pizza Hut. On delivery side, our combined delivery sales between Pizza Hut Casual Dining and Pizza Hut Home Service grew about 40% from first-quarter 2016 to first-quarter 2017. In the first quarter, mobile payments accounted for 28% of our Pizza Hut Casual Dining's company sales and also the loyalty program increased to over 23 million members. Digital and delivery are the key drivers for our same-store sales growth. We will continue to focus on these initiatives to drive the momentum.

Now, let's move to slide 20. We have identified our near-term opportunities and have taken immediate actions to address that. First, leveraging KFC's successful digital initiatives, we have allocated more resources to enhance our digital marketing capabilities at Pizza Hut. Second, our initial observation at Pizza Hut is that there is room for improvement in food innovation, both for core products and other items such as drinks and snacks. We actually worked very hard to offer better food to our customers.

Third, we will optimize our asset portfolio and we are developing multiple business models to address different consumers' needs. Last but not least, we have identified some low hanging fruits to improve operational efficiency. Importantly, we are also working on the long term strategic plan of Pizza Hut, and the integration of Pizza Hut Casual Dining and Home Service businesses to drive sales growth and increase profitability. That concludes my presentation on brand performance. Let me turn the call over to Ted, our CFO.

Ted Stedem - Yum China Holdings Inc

Thanks, Joey, and good morning to those calling in from Asia and good evening to those in the US. During our previous calls, we have highlighted several unique strengths that truly differentiate Yum China in the marketplace.

First, we operate the leading brands in the biggest growth market in the world for the restaurant industry. Second, we have an experienced management team that knows how to operate and grow them. And, finally, as China's biggest restaurant operating company, we have unmatched resources, capabilities and financial strength to capitalize on the growth opportunities in front of us. This morning I'll provide you with a high-level overview of our first-quarter results which highlight some of the strengths of the Yum China model.



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On slide 22, we are very pleased that we delivered positive same-store sales growth and strong profit results during the first quarter despite the challenging lap. Turning to system sales, we delivered 4% system sales growth excluding the impact of foreign exchange. Our companywide restaurant margins reached 23%, a year-over-year increase of 3.7 percentage points. Adjusted EBITDA was \$320 million which represents an increase of 20% year-over-year excluding the impact of foreign exchange. And, finally, our operating profit was \$254 million, an increase of 27% year-over-year excluding the impact of foreign exchange. Both our margin and our operating profit performance was primarily aided by the benefit from the retail tax structure or VAT reform.

Please note that lapping of leap year in Q1 2016 negatively impacted our operating profit by about \$6 million and our systems sales growth by 1% on a constant currency basis in Q1 2017. Consistent with past practice, we have removed the leap day sales from our same-store sales growth calculation. Therefore, the extra day had no impact on our reported 1% same-store sales growth in Q1 2017.

Let's turn to slide 23 where you can see some of the new restaurants that we've opened recently. During the first quarter, we opened 133 restaurants across China. Thanks to our flexible approach to development and deployment of multiple business models, we have continued to open new restaurants across every city tier and trade zone with about 56% of our new builds opening in lower tier cities. We are also seeing encouraging results when we open restaurants in new cities, and we entered 9 new cities during the quarter.

Due to the solid operating results for both KFC and Pizza Hut during the first quarter, our average new unit returns continue to be healthy. At the end of the first quarter, the average new restaurant pretax cash payback periods are less than three years for KFC and less than four years for Pizza Hut. Yum China is one of the most experienced restaurant developers in China, and we are uniquely positioned to capitalize on the long runway for new unit growth. Our full-year gross new restaurant opening target remains unchanged at 550 to 600 restaurants.

Let's turn now to slide 24, which shows the restaurant margins and operating profit results for KFC and Pizza Hut Casual Dining. At KFC, which generated approximately 75% of our total segment profits in the quarter, restaurant margins were 23.6% up 2.4 percentage points year-over-year. And operating profits were \$207 million up 14% year-over-year excluding FX. The increase in KFC restaurant margin and operating profit was primarily aided by the impact of the VAT reform. In addition, the increase in same-store sales contributed positively to margins. These benefits were partially offset by food inflation, labor inflation and our decision to upgrade the quality of certain KFC products including our French fries.

At Pizza Hut Casual Dining, restaurant margin was 23%, up 7.2 percentage points year-on-year, and operating profit was \$65 million, up 75% year-on-year, ex-FX. The increase in Pizza Hut restaurant margin was primarily aided by the impact of the VAT reform. In addition, we realized significant improvements in productivity as sales turned from negative to positive from Q1 2016 to Q1 2017. These benefits were partially offset by labor inflation and food inflation.

Q1 is a high season for sales and margin for Yum China due to the Chinese New Year holiday. While we are pleased that restaurant margins exceeded 23% for both KFC and Pizza Hut Casual Dining during the quarter. These results should not be extrapolated to other quarters.

Finally, as I mentioned, our Q1 restaurant margin and operating profit results benefited substantially from the VAT reform. For detailed discussions on the benefit and other impacts of the VAT reform, please refer to our last earnings release and 10-K. We will begin lapping the implementation of the VAT in May, which is the final month of our fiscal second quarter.

Now on slide 25 there are several items that impacted our Q1 financial performance that I would like to point out, including currency translation, G&A and inflation. Foreign currency translation negatively impacted our operating profit by \$12 million. Based on the current RMB to dollar spot rate, versus the average translation rate we incurred for our 2016 results, this negative impact may continue in future quarters. G&A increased 5% in local currency mainly due to higher compensation and headcount. We continue to expect full-year G&A growth in the high single-digit range, ex-FX, primarily due to higher compensation and public G&A costs.

Finally, on restaurant level inflation, our wage inflation was 7% and our commodity inflation was 4.5% during the quarter. We believe that commodity inflation will be the highest in the first quarter and we expect it to moderate throughout the rest of the year. We estimate our full-year commodity inflation will be approximately 3%.



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Let's move on to slide 26, which highlights one of the most powerful components of the Yum China model: our ability to generate substantial free cash flow. During the first quarter, we generated net cash flow from operations of \$357 million and free cash flow of \$283 million after subtracting \$74 million in capital expenditures. Our balance sheet remains strong with over \$1.25 billion in cash and short-term investments.

Earlier this year, we announced that our Board had authorized management to repurchase up to \$300 million of our shares, and we remain committed to returning excess cash to shareholders. Our top priority is to invest and grow our core brands over the long-term through our initiatives to drive same-store sales, our industry-leading new unit development, remodels and brand projects that contemporize the customer experience.

We are also evaluating growth opportunities beyond the core brands that leverage our unique strengths and capabilities as the largest restaurant operator in China with a world-class supply chain network and logistics capability, and the largest restaurant customer loyalty program and delivery network in China. We look forward to reporting back to our investors on both our growth strategy and our capital allocation plans later this year. With that, I will turn it back over to Micky for a quick summary before we take Q&A.

Micky Pant - *Yum China Holdings Inc*

Thank you, Ted. So, as Ted said, before we open up for Q&A, I'd like to use slide number 27 to give you a summary of our quarter and outlook for the future. Our first-quarter performance gives us greater confidence in our ability to deliver 550 to 600 new units coupled with double-digit operating profit growth excluding the impact of foreign exchange.

With increasing confidence in the performance of our business, we are focused on three priorities. The first priority remains the continued growth of same-store sales growth. And, in particular, we view digital and delivery as our compelling competitive advantages. Secondly, we have embarked on a comprehensive strategic plan for Pizza Hut. This covers the revitalization of our dine-in business, integrating our growing delivery business across all channels and maximizing the opportunities from digital and loyalty programs. And lastly, we are very encouraged by our strong cash generation, as Ted mentioned, and are examining cash deployment opportunities right across the spectrum from growing our core business to growing beyond our core and, finally, returning excess cash to shareholders.

We will announce more details of this in subsequent quarters. For now, that concludes prepared remarks and I turn it over to Christie to commence Q&A.

Christie Ju - *Yum China Holdings Inc*

Thank you, Micky. Now we will open the floor for Q&A. We would like to take as many questions from you as possible and I would really very much appreciate it if everyone can limit to two questions each or if you have one question and follow up, that's fine, too. If you have more questions, feel free to go back to the queue and we will try again to take as many questions as possible. Tara, let's provide instructions for Q&A, please.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) John Glass, Morgan Stanley.

John Glass - *Morgan Stanley - Analyst*

Thanks very much. Micky and Joey, I have a question about sustainability of the same-store sales. Obviously, in the first quarter, you lapped a tough comparison successfully. How promotional were you to get that comp increase? Did you, for example, increase the level of discounting? Did you increase the level of the advertising? Can you speak to what you think the rest of the year looks like given that momentum and what you did specifically in those areas to drive those comps?



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Micky Pant - *Yum China Holdings Inc*

Thank you, John. I'll make a couple of quick comments and then hand over to Joey for more color commentary. I would like to clarify that in this call we are not providing same-store sales guidance for Q2 or for subsequent quarters of 2017. However, as we've said on the call multiple times, we are facing the future with increasing confidence and we are very encouraged by the performance of Q1.

I think, John, you will notice that we delivered positive same-store sales over a tough lap and at the same time, no compromise on margins or profitability. I think that should give you an idea that we were not overly promotional in being able to drive the same-store sales. We believe we are finally poised at this time and, like I said in my closing slide, our first priority above anything else is to continue to drive same-store sales growth. So with that, Joey, any further comment?

Joey Wat - *Yum China Holdings Inc*

Hi, John. As we learn, a successful campaign for the Chinese New Year or for any time is always the result of a combination of initiatives. So it's good product, promotional campaigns that resonate with customers and very, very solid store operations. So it's quite hard to say that it's just purely marketing campaigns. Let me start with KFC, and then a bit more comment on Pizza Hut.

KFC is real strength. It is the 300,000 strong store operations team who serves our customers day in and day out. We have solid programs throughout the year. We will stick to our plan and adjust our plans accordingly. But the key thing is a combination of initiatives, promotion campaigns to operations, good products. In terms of promotional campaign, it is a combination of traditional media and the new digital and also delivery.

For the Pizza Hut, I think we are all quite encouraged to see the first quarter is generating positive same-store sales growth, but I would like to highlight again that it was minus 12 last year same quarter. And also it's a big business. For any solid fundamental turnaround you expect 18 to 24 months. So for Pizza Hut this year, for the rest of the year, we, of course, are reviewing the marketing plan and the new product pipeline and we'll adjust as soon as we could and as much as we possibly could do. But again, we are also learning how to, through a combination of initiatives, to deliver solid sales momentum.

Micky Pant - *Yum China Holdings Inc*

Thank you, Joey. Next question.

John Glass - *Morgan Stanley - Analyst*

That's very helpful. If I could just ask one follow-up. On your real estate plan, you alluded to one that delivery is growing quickly. It is up 40%. It is 12% and you're also talking about maybe some store rationalization, so as you think about the future, do you need the stores as large as they are? Is there any opportunity to rationalize your existing stores? Do you think about a different kind of footprint going forward? A smaller footprint, perhaps given that more and more of your food is going to be off premise?

Micky Pant - *Yum China Holdings Inc*

I think, John, at the levels which we have placed where delivery is around 10% to 12% of our sales and the rate of increase that we are seeing, we don't see a significant wholesale change in our estate at all. We continue to be optimistic about building new units in addition to be able to deliver from existing units. I think on previous calls and in previous roadshows we have mentioned that we have been experimenting with smaller format stores with a lot of success, so changes like that will continue to happen.



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Delivery, however, is growing rapidly, and we keep you posted in subsequent quarters of any other further developments. But at the moment, at the thrust of your question is whether we need to substantially change our business model, the answer is no. I think we are doing fine where we are.

Christie Ju - *Yum China Holdings Inc*

Okay, thank you. Operator, can we have the next question, please?

Operator

Christine Peng, UBS.

Christine Peng - *UBS - Analyst*

Hi, management. I have two questions. One is for Ted. Hi, Ted. Could you give us a break down in terms of traffic and ticket size contribution to same-store sales growth of Pizza Hut and KFC, respectively, in the first quarter of 2017? And second question is, hi, Micky, I remember when Yum China presented Q4 results last year, you did mention that Tier 1, Tier 3 and 4 cities were kind of lagging -- were kind of dragging on to lead to less than satisfactory same-store sales growth in fourth quarter of last year. And how has that been changing going to first quarter of the year? Do you observe a pickup in the Tier 3 and 4 cities and traffic into the KFC and Pizza Hut restaurants?

Ted Stedem - *Yum China Holdings Inc*

Good morning, Christine. Let me take your question first, which was on the breakdown of our same-store sales by brand. So, for KFC, we were plus 1 and that was comprised of a negative 1% contribution from transaction and average guest check up 2%. Now the guest check did contain about two points of pricing and almost no mix benefit. On the Pizza Hut Casual Dining side, our Pizza Hut Casual Dining same-store sales were up 2% and that was comprised of a 2% increase in transaction and a flat guest check. We have negligible pricing -- had negligible pricing impact and Pizza Hut Casual Dining during the first quarter.

Micky Pant - *Yum China Holdings Inc*

Christine, this is Micky. To your second question, I think as we analyze our sales by tiers, we are pleased to see the performance of both brands across all city tiers. It is true from your recollection that last year that Tier 1 cities had a particularly strong performance, but we are pleased to see that we are able to lap those in all city tiers. City tier performance does tend to differentially act depending on the scope of the economy, but we believe that we are really well-balanced and very well poised across all city tiers so that we should be able to have a great deal of stability in the future. Thank you.

Christie Ju - *Yum China Holdings Inc*

Thank you. Can we have the next question, please?

Operator

Sara Senatore, Bernstein.



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Sara Senatore - Bernstein - Analyst

Thank you. Thank you very much. I have a follow-up question and then a separate question on margins. Just on the question of delivery or the topic of delivery, you've seen pretty dramatic growth there, very impressive, and I was wondering can you give us any color on what the average check might look like or how you think about incrementality? I'm just trying to understand given that delivery and digital are such important parts of your growth trajectory, is there a way for us to think about what the contribution might look like as that mix shifts higher in both directions, higher average check? Do you see greater frequency for people who use digital? Maybe just a little bit more color on that. And then I'll have a question on margin, please.

Joey Wat - Yum China Holdings Inc

Hi, Sara. For the delivery base, KFC is just -- the ticket average is about twice of our dine-in, basically so it's about RMB60-something. And then Pizza Hut is about RMB100, which is a bit less than our dine-in business. And both are growing very, very nicely. The key source of growth is both from -- for us from more what we call "zeng liang" in Chinese ; it's the pure volume side, the expansion of city coverage and also more frequency.

So, let me take KFC as an example. The KFC business side we are in 1100 cities. In delivery, we are now in about 650 to 700. So there are still more cities that we can expand our delivery business to and similar stories for Pizza Hut. And also in terms of frequency, the habit of delivery, food delivery is more well-established in top-tier cities, like Tier 1 cities. So right now our sales is growing very nicely in tier 1 and tier 2 cities. But the good news is the trend in the habit of the delivery is building out very quickly in lower tier cities and that gives us more opportunity as well.

Micky Pant - Yum China Holdings Inc

I think, Sara, just anecdotally, this -- it is a transformative sort of a situation. I think potentially because we see habits changing before our eyes and in our office over the last one year, the number of people that used to bring lunch from home compared to those who order now from restaurants is changing dramatically. And I think that overall, off-premise consumption is increasing and we are very pleased at the moment with the shape of our -- both our brands and the ability, especially coupled with our digital database and digital expertise. So I think it is significant. We'll give you more color commentary in subsequent quarters. You had a follow-up?

Sara Senatore - Bernstein - Analyst

That's great. Thank you. That's very helpful. Yes, very helpful, thank you. Just on the margin side, obviously you talked about how the VAT was a big part of the -- or the bulk of the margin expansion. Longer-term, if I think about mid single-digit or low single-digit food and high single-digit wage inflation, what's the right comp to think about as the point at which you can continue to see margin expansion or leverage, once you've obviously lapped VAT and that is no longer a tailwind? So just how to think about the leverage point in the operating model, please?

Ted Stedem - Yum China Holdings Inc

Thanks, Sara. That's a great question. I think looking forward and we do expect the labor inflation to continue in the high single digit range but I think the big question is where the food inflation and commodity inflation settles. The past four years we've had almost relatively flat commodity inflation. In Q1 it did pick up to 4.5% and we expect it to moderate throughout the balance of the year.

If you look at the combinations of these to grow our margins, with that we would need a solid comp. I think the benefits that we've gotten from our margin improvement, we still see margin improvement opportunities but they are going to be much less than we have seen in the past two years. So I think the margin expansion is going to have to come from our same-store sales growth, which is why we are committed to it.

We haven't set a specific target for that because we don't have full visibility to the commodity inflation, but it is safe to assume that we need solid same-store sales growth to deliver a margin expansion and I think that's why as management we made this an absolute top priority and we have



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a number of initiatives and strategies that we've shared with you around delivery, digital, innovation, value throughout the day that we are working on to make sure we can deliver that consistent comp to cover our inflation and to get margin expansion.

Micky Pant - *Yum China Holdings Inc*

Thank you. Next question.

Sara Senatore - *Bernstein - Analyst*

Thank you.

Operator

Anne Ling, Deutsche Bank.

Anne Ling - *Deutsche Bank - Analyst*

Hi, management team. First I have the store number questions. Just want to check, how many like self-run stores that were opened by brands, i.e., KFC and Pizza Hut for the first quarter? And for the full year of like 500 to 600, what is the mix now in terms of franchise? Was this on self-operated store? That's my first question.

Joey Wat - *Yum China Holdings Inc*

Anne, we will provide details once you see our Q so you will have that, which is coming in this week.

Anne Ling - *Deutsche Bank - Analyst*

Okay, okay. And my second question is on the Pizza Hut. You mentioned about a multiple business model that you are reviewing. Would you share with us what you have in mind in terms of the different business model type? And secondly, in terms of -- I think Joey mentioned that there's been some low hanging fruit. Is it already reflected in first quarter or would you give us some example in terms of what are the areas that we can fix -- which are easy fix and -- so that's my second question.

Joey Wat - *Yum China Holdings Inc*

Hi, Anne. Pizza Hut is a big portfolio. With that size of portfolio, we naturally can do some segmentation to serve our customers a bit better. So we are going through the exercise of dividing -- not dividing -- analyzing the store segmentation. I will give you one example. We are testing one model which is what we call bistro. Basically I think the other way the industry calls it "fast casual", you basically pay the bill first and you order and then you sit down. So that is just one of the models that we are testing, and we are testing multiple models. It is still early days, but it is absolutely the right thing to do. It is a must and we believe that we will find our way there.

In terms of low hanging fruits, I took over the business only back in February. So it's again, early days. But we do have short-term initiatives planned for the Pizza Hut team, and there are quite a number of low hanging fruit, again, we are testing or trying. One area is some items that we might take away from the core menu. Again, we are testing and we hope that every step is a solid step. So we are doing it in a cautious and careful way, even for low hanging fruits. And the other smaller things, which is absolutely right thing to do is, let's say, drink portions, the food portions... so let's start from the drink portions. We are upgrading the drink portions. Without charging customer more we are providing more drink and more food. So these are sort of the few examples that we are testing.



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Christie Ju - *Yum China Holdings Inc*

Great. Thanks, Joey. Can we have the next question, please?

Operator

Matt McGinley, Evercore.

Matt McGinley - *Evercore - Analyst*

Thanks for taking my questions. The first one is on the margin. In your prepared remarks, Ted, you noted a few times that the increase in margin and profit growth was primarily aided by that VAT change, but you also mentioned some efficiency gains. Can you give us some sense of what the efficiency benefits were net of that VAT? The VAT benefit seems to have gone up in every quarter but it sounds like there are some other good things that are going on there that it's a little bit hard for us to tease out in the numbers given the big move in the margin rates on a quarter to quarter basis.

Ted Stedem - *Yum China Holdings Inc*

Sure, Matt, let me split it for KFC and Pizza Hut. And really the -- when you look at the lapse in the quarters, KFC's margins were up a little over two points, 2.4 points and Pizza Hut's margins were up 7.2 points. KFC was lapping a plus 12% same-store sales growth with a plus 1% same-store sales growth. Typically in our business when you lap a plus 12 with a plus 1 you wouldn't expect a lot of productivity and efficiency gains, and the contribution to KFC's margin was minimal.

Pizza Hut, on the other hand, was lapping a negative 12 and we had efficiency gains in a couple of areas I will walk you through. I mentioned labor productivity. That efficiency gain comes from the fact that we delivered a plus 2 and also the fact that we had an underperformance last year. So we had an important pickup of labor productivity. The other area we picked up efficiency in Pizza Hut was in cost of sales where we were lapping a promotion that underperformed, so we actually had a pickup because the promotion, as Joey mentioned, performed quite well.

I also would highlight that during the first quarter, we also had a benefit in our utilities expenses that we believe was related to lower consumption due to the unseasonably warm weather that we had throughout the country. So those would be some of the areas that we've picked up outside of the VAT. Obviously, on Pizza Hut, we also had a pickup from the sales growth that we delivered in the margins.

Matt McGinley - *Evercore - Analyst*

Great. And on the store growth in this quarter, the first quarter is not -- or has not historically been a quarter where you would put up a lot of stores because it's a short quarter and you have the holiday. What was different this year was that you had the opportunity to put up more stores. And -- I guess the net number of stores was up quite a bit year-over-year because you have fewer closures, too. So can you kind of give a sense of what was different this year with that and why the closures were quite a bit less?

Micky Pant - *Yum China Holdings Inc*

Yes, I think we give the gross number, I think 133, which was well above last year. Q1 does tend to be slow normally on account of Chinese New Year construction activity and worldwide, in general -- a lot of stores do get built in the fourth quarter but I wouldn't read too much into it at this stage, Matt. I think you would be wise to stick do with our guidance of 550 to 600 new unit builds. Like we said, we feel even more confident about it having gotten off to 133 stores in the first three months of the year, but I wouldn't raise our expectations on new unit builds just based on the first quarter. Let's just see how the subsequent quarters go and then we can keep you posted.



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Christie Ju - *Yum China Holdings Inc*

Thanks, Matt.

Matt McGinley - *Evercore - Analyst*

Okay, great. Thank you.

Christie Ju - *Yum China Holdings Inc*

Operator, can we take the next question, please?

Operator

Brian Bittner, Oppenheimer.

Mike Tamas - *Oppenheimer - Analyst*

Hi, great. Thanks. This is Mike Tamas on for Brian. You guys talked about the cash balance and your significant free cash flow generation, so just curious what the thoughts are using that cash going forward? I know you have a buyback authorization out there but don't think you bought back any stock this quarter. So just curious how you are thinking about that and potential uses going forward? Thanks.

Micky Pant - *Yum China Holdings Inc*

I think, Brian, I will hand over to Ted for this, but like I said at my concluding slide, you'll have to wait a little longer for us to give you more details of that but I'll let Ted give you as best an answer as we can.

Ted Stedem - *Yum China Holdings Inc*

Thanks, Brian. I think this is one of the most important questions that as management we are tackling and we are working and exploring all of the options and it's a top priority for us. I want to clarify one point. The \$1.25 billion that we have in cash includes the operating cash flow requirements, the working capital requirements of the business which are about \$500 million. With that said, as management we are absolutely committed to either investing our cash to grow our business or returning it to the shareholders either through buybacks or dividends.

You mentioned that we already have approved a \$300 million share repurchase program. Beyond this, our top priority is to invest and grow the core restaurant brands by investing in new stores, remodels or brand projects. As I mentioned in conjunction with Joey, we are exploring all opportunities to do this. We've also commenced a review to evaluate the opportunities to invest in other growth options that leverage the unique strengths of the Yum China model and we will expect to complete this review in the second half of 2017. And therefore we look forward to updating you when we complete the review and that's going to be a review of our internal growth options and any other opportunities we see as well as our plans to return any excess cash to shareholders through buybacks or dividends and we plan to come back to you later this year with more clarity on those plans.

Christie Ju - *Yum China Holdings Inc*

Thank you, Ted. Can we have a next question? Do you have another question, Mike?

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Mike Tamas - *Oppenheimer - Analyst*

If I may. It's sort of been asked a couple of ways a few times about the VAT benefit but just curious if you can quantify it this way: if you didn't have the VAT benefit, would margins have been up year-over-year in the first quarter? Just kind of curious on how to think about that? Thanks.

Micky Pant - *Yum China Holdings Inc*

Mike, it's a tough one to answer, as you can imagine, but just remember the VAT is an industry benefit. It's not as though the government cut us a check for that amount. This was a tax benefit enjoyed by every competitor as well. The second is that, as you know, we've had relatively modest pricing and it might've been different had VAT not occurred. So it's very difficult to estimate what may or may not have happened.

It's definitely a positive benefit for us. I think more importantly a very important sign from the government wanting to continue to stimulate the economy and it's been positioned as such, and we've been very encouraged by it. It gives us unprecedented cash and operating margins to be able to invest even more strongly behind the business. But it's very difficult to answer what might or might not have happened had VAT not occurred.

Mike Tamas - *Oppenheimer - Analyst*

Thank you.

Christie Ju - *Yum China Holdings Inc*

Okay. Operator, can we take the next question, please?

Operator

R.J. Hottovy, Morningstar Research.

R.J. Hottovy - *Morningstar - Analyst*

Thanks. Had two questions both related to the loyalty membership program. The first question, I was wondering if we could get some details on the typical profile of your loyalty membership program member, things like demographics, household income, potentially even Tier 1 versus lower tier cities. Just trying to get a sense of where you are seeing that customer acquisition, that member acquisition, just better understand the profile of that customer.

The second question I had is now that you've starting to lap growth on that, have you seen any change in behavior for, particularly among those customers that you've had for more than a year in terms of average order size, average frequency of order? Just any kind of details that you might have on that front would be helpful. Thanks.

Micky Pant - *Yum China Holdings Inc*

Okay, Joey will answer that one.

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Joey Wat - Yum China Holdings Inc

Yes, for the typical profile, this is an interesting one because for, let's say for a typical KFC customer, our target customer is from 3 to 80 years old, so it's quite hard to come up with a typical profile. But in terms of members, they tend to -- the range of age is a bit narrower than our target audience. So the younger people is something we can expect.

In terms of what have we learned from our customers, we are very pleased about our customer's loyalty really. Again, take KFC as an example, right now with our 70 million members, 25% of our business from our members, and that's huge proportion and what can we learn from them? We are still learning, because it is still early days. And in terms of frequency, we -- of course, we are doing naturally with this huge amount of database, we are doing customer segmentation, and try to understand their frequency and then how can we get more frequency. But just to give you a bit of color, very loyal KFC customers in our pyramid, they do come to our store on a monthly basis. So it's quite high for our industry or retail industry in general. Thank you.

Christie Ju - Yum China Holdings Inc

Okay, can we -- given we are already close to one hour mark, can we take the last question, please?

Operator

Christine Peng, UBS.

Christine Peng - UBS - Analyst

Hi, management. Thank you for taking the follow-up questions. So on Joey's comment you mentioned that 25% of revenue of Pizza Hut -- of Yum China come from the membership. Can you give us an idea what this number was, for example, one year ago in the first quarter of 2016? And is that convenient for you also to provide us the proportion of revenue coming from members for Pizza Hut and KFC, respectively, in first quarter of this year? That's my first question.

And second question is for Ted. Hi, Ted, I realize since early this year, Pizza Hut Casual Dining is combined with home delivery, so in terms of financial reporting, will there be any differences going forward given that the Pizza Hut home delivery previously was accounted in other revenue section? Thank you.

Christie Ju - Yum China Holdings Inc

Christine, it's Christie here. I will take the first question. As Joey mentioned, I think, obviously, we are following very closely other membership and early data but we are in very early stage. As you know in 2016, that was the time when we started the membership program, so a lot of information are still being gathered and there is very limited comparison and in terms also the contribution for sales varies from period to period. There is also differences across different regions. I think we would rather have more data and have more concrete evidence before we provide a more historical breakdown.

Christine Peng - UBS - Analyst

Okay. No problem.

Joey Wat - Yum China Holdings Inc

(multiple speakers) and the 25% is for KFC only not for Yum China, Christine, just to make sure I make myself clear.



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Christie Ju - *Yum China Holdings Inc*

Okay, and Ted will answer your last question.

Ted Stedem - *Yum China Holdings Inc*

Okay. Hi, Christine. On the reporting question, we are working with Joey right now. We are developing a detailed Pizza Hut growth strategy that leverages both the resources we have at Pizza Hut Casual Dining as well as Pizza Hut Home Service. And as we crystallize that strategy we will evaluate the best way to report that business, so I don't have anything concrete to give you today, but know that we are working on a strategy for the Pizza Hut brand and that we will come back to you if we think we should change the reporting structure and that will be at a time in the future.

Micky Pant - *Yum China Holdings Inc*

Say as we conclude the call, Christine, since you follow the company so closely, and to others listening on the call, numbers related to loyalty program membership impact on the business at the moment should not be taken as firm numbers that we have given at the moment. We reported a number of times, for example, the percentage of business coming from cashless payment, which is trending at about a third and the number of loyalty club members. But please don't take the percentage of sales being derived from loyalty as a firm number at this stage. We will provide more commentary as this goes along, so as Christie was saying, it's a little early at this stage to be able to take those numbers and use them for modeling purposes in any way.

Christine Peng - *UBS - Analyst*

Okay. (inaudible) Thank you.

Christie Ju - *Yum China Holdings Inc*

Thanks. Thanks, everyone.

Micky Pant - *Yum China Holdings Inc*

Okay. Well thank you, everyone, for being on the call and I guess we return it for the conclusion of the call.

Christie Ju - *Yum China Holdings Inc*

Yes, for those of you who have additional questions, feel free to reach out to us. We are here to answer your questions and many of you already know we will be in Singapore next Monday and in Hong Kong Tuesday in Wednesday and we look forward to have more opportunity to interact with all of you. Thanks very much.

Operator

Thank you. Ladies and gentlemen, this does conclude our conference for today. Thank you so much for your attendance. You may all disconnect.



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