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YUMC - Q2 2017 Yum China Holdings Inc Earnings Call

EVENT DATE/TIME: JULY 06, 2017 / 12:00AM GMT

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by and welcome to the Yum China 2017 second-quarter earnings conference call. (Operator Instructions). I must advise that this conference is being recorded today, Thursday, July 6, 2017. I would now like to hand the conference over to your first speaker today, Ms Christie Ju, VP of Finance, Head of Investor Relations at Yum China. Thank you. Please go ahead, Christie.

Christie Ju - *Yum! China Holdings, Inc. - VP of Finance & Head of IR*

Thank you, Joan. Good morning and good evening, everyone. Welcome to Yum China's second-quarter 2017 earnings call. Please note a PowerPoint presentation and live broadcast of this call are available through our IR website under the Events & Presentations section.

Joining me today are our CEO, Micky Pant; President and COO, Joey Wat; and interim CFO, Jacky Lo. We will start with opening remarks from Micky, Joey and Jacky 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 and all forward-looking statements should be considered in conjunction with the cautionary statement in our earnings release and the risk factors included in our filings with the SEC.

Let's start with page 3, the agenda. Micky will discuss second-quarter highlights and the Daojia acquisition. Joey will review brand performance and digital and delivery. And then Jacky will summarize our financial results. After their opening remarks we will be happy to take questions from analysts and investors. Now let me turn the call over to Mr. Micky Pant, CEO of Yum China.

Micky Pant - *Yum! China Holdings, Inc. - CEO*

Thank you, Christie. I would like to add my welcome and greetings to you from our headquarters of Yum China here in Shanghai. If you have access to our presentation online, I will start with slide number 4.

Our second-quarter results continue to illustrate strong performance at Yum China with overall same-store sales growth up plus 3% and system sales up plus 7% before foreign exchange translation. KFC delivered strong performance with same-store sales up plus 4% and Pizza Hut same-store sales were flat with a year ago.

Operating profit increased sharply plus 64% to $143 million, primarily aided by the benefit of retail tax reform and same-store sales leverage. On a fully diluted basis, our EPS was $0.27, up 29% year on year.

We opened 90 new restaurants and remodeled nearly 200 stores led by KFC. We had a total of 7,685 restaurants at the end of Q2.

Now in previous calls we have highlighted our growing strength in digital and delivery and we continue to make progress in this vital strategic frontier. With over 4,900 restaurants offering delivery service, total delivery sales in the quarter reached $200 million, which is about 13% of our total Company sales.

Mobile payment represented about 40% of our total Company sales and cashless payment reached a record of $900 million in Q2 alone. Our loyalty members for both brands surpassed 100 million in total with 83 million and 26 million members at KFC and Pizza Hut respectively. Joey Wat will share more details later.

Finally, two other highlights for the quarter; the first was our acquisition of Daojia, an online delivery company. We acquired an 80% stake on a fully diluted basis for a total cash consideration of $61.7 million, including $36.7 million to selling shareholders and $25 million in a capital contribution.

Lastly, we repurchased the Yum China shares at $39 million at an average price of $36.27 per share during the quarter. So overall we are pleased with solid progress during the quarter and now let me give you some details of sales, margins and our Daojia acquisition. So I will draw your attention now to slide number 5.

As you can see on this slide, our same-store sales growth and system sales performance have been shown for the past six quarters. The chart on the left shows same-store sales growth for the Company and, as you can see, the trend is encouraging. In Q1 we were able to lap a very strong Chinese New Year and in Q2, our most recent quarter, we lapped a flat performance with plus 3%.

The chart on the right shows the corresponding numbers for system sales and here again the overall trend is in the right direction.

At this time I wish to reiterate that same-store sales growth are always difficult to forecast. Our experience suggests that same-store sales growth can sometimes be subject to external factors that are not fully in our control. Having said so, we remain very optimistic about the long-term future of China and we view the near-term with confidence.

Now let's move to slide number 6. As you may be aware, since May 1, 2016, the impact of the VAT reform has been contributing to growth in Yum China margins. Restaurant margin improved by 2.7 percentage points to 15.3% due to the VAT benefit and due to same-store sales leverage, offset by some inflation in the quarter. Our operating profit grew 64% to $143 million. You will get more details of our financial performance from Jacky Lo later.

Now if you move to slide number 7, I would like to make a few comments about our Daojia acquisition. We have acquired two brands, Daojia and Sherpa's, and both are online aggregator platforms focused on the higher end of the delivery market.

Daojia was founded in 2010 by Hank Sun who will continue to be the general manager of the acquired entity. Sherpa's has a significant presence in the market for English-speaking expatriates and has been operating for 18 years. Yum China has acquired 80% equity interest on a fully diluted basis for a consideration of about $61.7 million. Please note that of this amount, $25 million is the capital contribution which will be used to fund the operations of Daojia.

The strategic rationale for this acquisition is threefold. First and most important, we have a rapidly growing delivery business in our existing brands and we wish to increase our know-how and expertise in this important and growing market.

Secondly, Daojia is focused on the higher end of the market and we would like to develop more expertise in the segment.

Thirdly, there are rapid technological and operational changes ongoing in the entire restaurant industry and we believe that the expertise we are acquiring from Daojia will help us improve our logistics efficiency as we continue to grow our business.

Please note, as mentioned in our previous press release, we do not regard this acquisition as material to our opening performance given the size of our Company.

So that concludes the overall highlights of Q2 for Yum China. I will now hand you over to Joey Wat, our President and Chief Operating Officer, to take you through the performance of our brands. So Joey, with that it's over to you.

Joey Wat - *Yum! China Holdings, Inc. - President & COO*

Thanks, Micky. Greetings, everyone. Now let me summarize the performance of KFC and Pizza Hut in the second quarter of 2017. Let's start with KFC.

As you look at slide 9, we have some key highlights of KFC in the quarter. KFC delivered plus 4% same-store sales and system sales were up 8% year on year. In this quarter we built 62 new stores and remodeled 180 units. Year to date we have built 134 stores and remodeled 205 units. Our financial performance was equally strong; both operating profit and restaurant margin improved. Jacky will cover the numbers in more detail.

Slide 10; let's take a closer look at the same-store sales and system sales for KFC. We had positive momentum at KFC in the past few quarters with improved growth in same-store sales and system sales. Same-store sales growth in Q2 was driven by transaction growth. In addition system sales growth also improved to 8% due to new store openings.

On page 11, in the second quarter KFC conducted a series of marketing campaigns with innovative seasonal products and integrated marketing activities to contemporize the brand image. For example, our Avocado Range was introduced with a focus on healthy eating; the Pink Cola and Matcha ice cream attracted customers with their unique appearances and great taste.

In Q2 we launched a new chicken bucket at a very attractive price of RMB39, leveraging the youthful and highly popular celebrity Lu Han with a mix of new Hong Kong flavor (inaudible) chicken and Original Recipe Chicken. The bucket was very well received.

We also re-launched the wing bucket which is a proven traffic driver for its attractive price of RMB39 for 10 wings. We have been selling at this price for many years. We also promoted for the first time a jumbo wing bucket selling at RMB79 for 22 wings and also a combo of wing bucket and drinks.

To celebrate the Labor Day holiday, KFC collaborated with Chinese National Geographic on "Hello China" or (spoken in foreign language) campaign. A series of designer buckets were introduced, each featuring a very different city in China. The campaign promoted the fascinating landscape of China and it resonated well with our customers.

Dragon Boat Festival, (spoken in foreign language), was another highlight in Q2. We introduced a Dragon Boat bucket, which offered a combination of rice dumplings, or (spoken in foreign language), and our signature chicken products. This creative product provides a unique connection between the East and the West while offering good value for customers.

Now let's move to slide 12. Here is an update on KFC digital and delivery efforts. In the second quarter over 45% of KFC's Company sales were made through a mobile payment, more than double that of the same period last year. And we really only introduced mobile payments back to 2015 in July. These numbers indicate that digital and delivery continue to drive growth and then delivery contributed to over 10% of total sales and it was up over 40% year on year.

In Q2, we also collaborated with online aggregators on digital marketing to boost transactions. We went with AliPay on May 20, cyber Valentine's Day celebration, or (spoken in foreign language), to help drive mobile payment penetration for example.

That concludes my comments on KFC. So if you move to slide 13, let me share a few highlights on Pizza Hut business.

As we have taken some steps to integrate Pizza Hut Casual Dining and Pizza Hut Home Service, we are reporting the performance of Pizza Hut in a consolidated format starting this quarter. In the second quarter, same-store sales were flat from last year while system sales increased 7% on a constant currency basis. We built 25 new stores and remodeled 17 stores. On the profitability front, Pizza Hut's restaurant margin improved to 13.9% with robust operating profit growth.

On page 14, let's take a closer look at the same-store sales and system sales, Lapping a 10% decline in Q2 2016, Pizza Hut same-store sales were flat in the second quarter, which underscores the challenges we faced in the Pizza Hut turnaround. As we will lap minus 4% and minus 3% same-store sales growth in the second half of the year, we expect the challenges to drive sales growth will be even tougher. On the other hand, our system sales trend is encouraging. We delivered 7% growth year on year in the second quarter.

Now let's review product innovation and marketing campaign on slide 15. As discussed before, we see product innovation as the core focus for Pizza Hut turnaround. Here are a few new items introduced in the second quarter.

First, a 750 ml Jumbo Fruit Tea, a good combination of fruit cup and tea, it's priced at RMB19. Now how big is 750 ml? It's the standard size of a bottle of wine. It is Instagram worthy and provides good value for increasingly health-conscious customers. It became an instant hit as soon as it was introduced, especially among the younger customers.

On the back of strong popularity of European-style pizza we launched a series of Thin Crust Pizzas in May. We conducted an interactive promotional campaign featuring a young and upcoming celebrity. Our promotional activities generated good social buzz among young adults and teens. Relevant posts and retweets generated over 100 million reads. The initial response to the Thin Crust Pizza campaign was encouraging.

In addition, we collaborated with Shanghai Fashion Week on fashion shows to help rejuvenate our brand image. We worked with young Chinese artist to create unique designer clothing for Pizza Hut employees as well. So this novel campaign also attracted young audience and generated good social media buzz.

These are just some initial steps we took on product innovation and marketing campaigns. We are testing a number of new initiatives and we are learning a lot of consumer insights. I would like to emphasize that there is still a long way to go to turn around Pizza Hut and we are working diligently to get things done.

On slide 16, here is our update on digital and delivery at Pizza Hut. Leveraging the expertise from KFC, Pizza Hut also collaborated with AliPay for the May 20 cyber Valentine's Day. In Q2 mobile payment accounted for around 31% of Pizza Hut Company sales and sales from delivery grew about 40% year on year to about 20% of total Company sales.

Slide 17, I would like to discuss some initiatives we are working on to revitalize Pizza Hut. The first step of Pizza Hut turnaround is to start from fundamentals. These include full innovation, menu integration and revamped customer service to improve dining experience.

Second we are leveraging KFC's digital expertise to enhance our capabilities in consumer engagement to drive digital campaigns and boost sales.

Third, we believe there are opportunities to target different segments with diversified business models; therefore we are testing new store formats such as small stores to satisfy different customer needs.

Last but not least we are consolidating the delivery network under Pizza Hut to improve coverage and efficiency.

On page 18, now I would like to shift gears from brand performance to a very important strategic initiative, digital and delivery. In the past few years we have developed and instituted a powerful plan towards becoming a leading restaurant brand of the future, creating an expanded runway for growth for Yum China. The things we have invested in, our loyalty program, digital and delivery capabilities and the restaurant of the future format, are shaping China's restaurant industry today.

Let me provide an update on our digital and delivery initiative for both KFC and Pizza Hut. Move to slide 19; we continue to strengthen our industry-leading loyalty membership program at KFC and Pizza Hut. Total members have surpassed 100 million at the end of second quarter. KFC alone has 83 million WOW members.

As mentioned before, we are shifting priority from growing members to engaging our members better. KFC's 30-year anniversary celebration has helped to build an emotional connection with our customers. We launched a member's day program for KFC and Pizza Hut, providing members only special offers. We also started to customize product offerings such as birthday privileges.

While still in the early stage, we believe these initiatives will keep our members engaged and help to drive frequency of their visits. We believe we have strong brand equity and see our membership program as a vital asset. We will continue to explore ways to leverage our member base to build sales.

Turn to slide 20. KFC has been the leading brand for our digitization. Mobile pre-order, mobile payment, delivery service and membership program helped drive efficiency and enhance customer engagement. More importantly, the 83 million members provide us a valuable database to understand our customers and serve them better. We will continue to embrace new technologies and apply the successful experience to other brands in our portfolio to drive further growth.

Let's turn to slide 21. Here are some examples of digital marketing campaigns in the second quarter. Pizza Hut started to use the digital platform to engage with customers. We launched a week-long digital membership promotion in May with limited offering coupons available for members through the digital platform each day.

As part of KFC's 30 years anniversary celebration we brought back the highly popular beef wrap (spoken in foreign language) including a member only privilege for first three days. This promotion ignited huge buzz on social media. Our beef wrap was ranked number four on Weibo Hot Topic. The campaign was very successful in driving traffic.

Another example was our collaboration with Xue Zhiqian, a popular singer, songwriter to promote our Born to be a Wing Fan campaign on his concert tour. This event was very well received and created good social media buzz as well. We have been trying different kinds of digital membership engagement. Despite some initial success we are learning a lot and there is still a long way for us to learn and release the power of our loyalty program.

We have built an extensive delivery network over the years. KFC started delivery service in 2007 and Pizza Hut started even earlier, back to 2001. Given the surge in consumer demand and emergence of aggregator delivery platforms, we have accelerated our delivery network expansion since 2015. At the end of the second quarter, over 4,900 of our stores across China offered delivery services.

Integrated marketing is the key to the success of growth of delivery. In Q2 we worked with aggregators to drive Pizza Hut sales. We also offer great deals at KFC to capture sharing occasions and trade up. Digital has been an enabler to make our products more accessible to consumers.

We leverage our own digital platform and member base to drive frequency and penetration such as own-platform exclusive offers. While we have had some initial success in digital and CRM, we see abundant opportunities ahead and will strive to capture future growth opportunities.

Now that concludes my remarks. Let me turn over to Jacky.

Jacky Lo - *Yum! China Holdings, Inc. - Interim CFO, VP, Controller & Principal Accounting Officer*

Thank you, Joey. Good morning to those calling from Asia and good evening to those calling from the US. You may recall that during our previous calls we identified several priorities for this year. First, we want to build on the positive momentum of KFC. Second, we intend to integrate the casual dining and home service businesses of Pizza Hut to drive greater brand focus. And finally, we plan to invest in long-term growth and create shareholder value with an effective capital allocation strategy.

This morning I will provide you with my thoughts on the progress we have made in the priority areas and a high level overview of our second-quarter results.

Now let's turn to slide 24. I am pleased to report that we delivered solid profit growth in the second quarter. On the back of healthy revenue growth and margin expansion our adjusted EBITDA increased 21% year on year and our operating profit increased 73% year on year, excluding the impact of foreign exchange.

Turning to system sales growth, in the second quarter our system sales grew 7% excluding the impact of foreign exchange. And during the quarter, we opened 90 new restaurants. The development was across all tiers, slightly skewed towards lower tier cities.

Additionally, to enhance our brand image and customer experience we remodeled 197 units. So solid execution of our development plan, successful marketing campaigns and innovative product rollout contributed to our system sales growth momentum. Our restaurant margin reached 15.3% during the quarter, up 2.7 percentage points year on year. And I will elaborate more on the drivers for restaurant margin expansion in the subsequent slides.

Moving on to slide 25, let me give you more color on our biggest brand, KFC. During the quarter, KFC's marketing campaigns and products clearly resonated well with consumers. The KFC team generated tremendous buzz around our products by leveraging on the 30th anniversary theme our loyalty membership program and the social media.

In addition, digital and delivery also contributed to the healthy same-store sales growth momentum. We are pleased that restaurant margins increased 2.2 percentage points and operating profit increased 48% year on year excluding the impact of foreign exchange. This was due to the favorable impact of the retail tax structure reform and also driven by same-store sales leverage. These benefits offset wage inflation, commodity inflation and promotion impact and we will elaborate more on the inflation later on.

Turning to slide 26, as we have previously announced, we want to sharpen our focus on the Pizza Hut brand and improve operational efficiency. So starting from the second quarter, we have combined Pizza Hut casual dining and Pizza Hut home service into one reportable segment. The new reporting structure reflects how we as management review and evaluate operating performance.

Now let me touch on the factors that contributed to this quarter's results for Pizza Hut. Similar to KFC, Pizza Hut also benefited from the impact of the retail tax structure reform. This benefit offset higher labor cost and commodity inflation. As a result our restaurant margin increased 3.5 percentage points year on year and operating profit increased 174% year on year excluding the impact of foreign exchange.

As Joey mentioned earlier, we are still in the early stage of our integration project and as we enter the second half of the year, the lapping of prior year same-store sales growth will get tougher and, accordingly, operating profit growth may also be impacted. Integration of the brands will take time and we are aware of the challenges ahead of us.

Now let's go to slide 27. There were several factors that impacted our second-quarter financial results that will probably continue through the rest of the year. First is restaurant level inflation. Our wage inflation was 7% and commodity inflation was 4% during the second quarter. While wage inflation is an inevitable challenge in the restaurant business, we will continue to find better ways to schedule our crew and streamline operating efficiencies and processes.

As for commodity inflation, we expect the rate to moderate through the balance of the year and we are maintaining our guidance of low-single-digit inflation for the full year. I would like to remind you that the retail tax structure reform, which is an industry-wide benefit, has contributed to our restaurant margin expansion since its implementation on May 1, 2016.

As we head into the third and fourth quarters, such year-on-year margin benefit will diminish and we will be lapping a high restaurant margin. Anticipating continuous restaurant level inflation, as I have just mentioned, we'll need same-store sales growth and productivity gains to sustain restaurant margins for all our brands. With that being said, we are committed to our long-term target of 17% restaurant margin for Yum China as a whole.

Second is G&A cost which increased 9% in local currency and mainly driven by higher compensation cost and public company expenses. For the full year, we continue to expect G&A increase of high-single-digit percentage excluding the impact of foreign exchange.

And third is currency translation. Considering the renminbi/US dollar spot rate versus the 2016 average rate, the negative currency translation impact may continue in future quarters.

Now let's move on to slide 28. One of the key features of Yum China's business model is our robust unit economics which translate into strong cash flow generation. Our average pretax cash payback period for KFC new unit is below three years. For Pizza Hut it is below four years.

We are able to maintain healthy returns in a highly competitive market because of our best-in-class infrastructure, development capability, product innovation and branding. And year to date in 2017, we generated free cash flows of $296 million. And our balance sheet remains strong with over $1.2 billion in cash and short-term investments.

Now turn to slide 29. Our top priority is to invest and grow our core brands over the long-term, but at the same time we are committed to creating value to our shareholders. There are three ways to deploy our cash in the best interest of shareholders: share repurchase, strategic acquisition and dividend payout.

And first on share repurchase, during the second quarter of 2017 we repurchased approximately 1 million shares for $39 million at an average price of $36.27. At quarter end, we have $261 million remaining under our current share repurchase authorization and we plan to execute the share repurchase program in the most effective way possible in future quarters.

Second, as Micky has already mentioned, we acquired Daojia, a strategic investment, to deepen our expertise in digital and delivery.

And now on dividend payout we are reviewing this important aspect of our capital allocation strategy. As you have seen in our financial results, we have a solid balance sheet and we are able to generate sufficient operating cash flow to support new unit development and still have excess cash. So by the end of the year we will report back to shareholders on this front.

As a public Company that has only been listed for less than a year, we have already commenced share repurchases and completed a strategic acquisition. So there is no question that we are committed to creating shareholder value. And we are building more know-how and strengthening our foundation in strategic growth areas.

And this wraps up my comments and I will turn it back to Micky to give you a quick summary and outlook.

Micky Pant - *Yum! China Holdings, Inc. - CEO*

Thank you, Jacky. So before we open up for Q&A, let me summarize and make some quick comments about the rest of the year and I am referring here to slide number 30. We delivered strong overall performance in the second quarter with two statistics of particular significance. Our loyalty membership program surpassed 100 million members and over 40% of our total Company sales were settled with mobile payment during the quarter.

Based on our first half performance, we feel confident that we will be able to deliver 550 to 600 new units coupled with double-digit operating profit growth excluding foreign exchange for the full year.

For the rest of 2017 we remain focused on three priorities. The first remains to build same-store sales with innovative products and creative marketing campaigns. Second, we are embarking on a comprehensive strategic plan for Pizza Hut; this covers revitalizing our dine-in business, integrating our growing delivery business across all channels and maximizing growth opportunities.

We are encouraged by our digital and delivery capabilities to drive long-term growth and shareholder return. Lastly, as Jacky mentioned, we are analyzing cash deployment opportunities to enhance value to shareholders and we will announce more details of this for subsequent quarters.

So that concludes our prepared remarks and now I would turn you over to Christie to commence the Q&A.

Christie Ju - *Yum! China Holdings, Inc. - VP of Finance & Head of IR*

Thank you, Micky. Before we start the Q&A, let me just highlight we have an upcoming Investor Day event in Shanghai. Yum China will host our 2017 Investor Day October 17-19. In addition to senior management presentations we will also have logistics center tour, new product testing at our test kitchen, store visit in Shanghai, Hangzhou and lower tier cities. And you will also have a chance to meet Daojia management for cocktails and industry experts including Ant Financial for lunch. Some of you are already registered, but if you haven't done so please contact us after the call.

Now moving on to the Q&A session, please. We would like to take as many questions as possible and would appreciate if you can limit your questions to two each. And you can go back to the queue for additional questions if you need it. Jo, we will be ready for the first question, please.

QUESTIONS AND ANSWERS

Operator

Thank you, Christie. (Operator Instructions). John Glass, Morgan Stanley.

John Glass - *Morgan Stanley - Analyst*

Thanks very much. Micky, thanks for the detail on the loyalty membership and the growth in that. What percentage of your transactions are tender on that loyalty program? Do you have the number for that?

Micky Pant - *Yum! China Holdings, Inc. - CEO*

No, we have not published those numbers yet, John. This whole thing has developed very rapidly. And I think as Joey said, that the impressive thing has been the rapid buildup of crossing 80 million members with KFC alone.

We are seeing encouraging signs, like the 30th anniversary campaigns, we were actually able to drive sales using the loyalty program. But as she said, I think it's still early days in determining what the impact of it is going to be on sales long-term. We regard it as a very promising area. So Joey, any further comments?

Joey Wat - *Yum! China Holdings, Inc. - President & COO*

No.

Micky Pant - *Yum! China Holdings, Inc. - CEO*

Okay, thank you, John.

Operator

Christine Peng, UBS.

Christine Peng - *UBS - Analyst*

Hi, management; I have two questions, one is for KFC. Hi, Joey, can you give us a breakdown for KFC same-store sales growth between transaction and ticket value? I think -- I remember you mentioned that transaction growth is the primary driver behind this 4% same-store sales growth. But I would like to get a detailed breakdown in terms of the transaction and ticket value.

And also, you mentioned delivery grew by 40% for KFC. Given the 4% same-store sales growth does that mean the KFC in-store, i.e. ticket value has turned flattish with previous declines for KFC?

Joey Wat - *Yum! China Holdings, Inc. - President & COO*

Okay. Is it your first question or all the questions? That's okay, all right. Okay, for the transaction the breakdown is 3% transaction, 1% on ticket average. The transactions mainly are coming from restaurants and our kiosks.

So I'd just like to remind you that while we always traditionally emphasize on transaction growth, but for us the most important thing is the total sales. Because when we grow our delivery business our transaction growth will go down as well because the ticket average will go up so there's always a balance between the two.

The second question is on delivery and I think we had that question before in previous meetings and my response remains the same. We don't look at the business that way because we play on our advantage, which is the fact that we have a very good number of stores, physical stores. And we drive the sales from each of the stores. It doesn't matter whether the sales is from delivery, or take-away or dine-in, as long as the store is growing the RGM is responsible for all the business.

Christie Ju - *Yum! China Holdings, Inc. - VP of Finance & Head of IR*

Thank you, Christine. Operator, can we have the next question please.

Operator

Sara Senatore, Bernstein.

Sara Senatore - *Sanford Bernstein - Analyst*

Yes, thank you very much. I wanted to ask about Pizza Hut if I could. Just when we were looking at the historical data it didn't look like maybe there was quite as much difference between dine-in and delivery in terms of same-store sales trajectory as we might have expected.

So I guess the first question is could you give some color on how delivery performance might compare with dine-in for that business? Because I think the perception is that the issue may be with the in-restaurant demand?

And then I guess on the same note could you maybe talk about relative profitability with those two businesses -- delivery, higher check but maybe more labor associated with it? And just in that context, to what extent do you think the issues at Pizza Hut are about the competitive environment, overall demand, or still something specific to maybe the execution around value or some of the other things you mentioned when you were talking about your strategic plan? Thanks.

Micky Pant - *Yum! China Holdings, Inc. - CEO*

Sarah, this is Micky. I will just start with the answer to your questions, then I'll ask Joey to fill in the gaps. Firstly, if you take the first half, that's Q1 and Q2 gone by -- and as you know with Q2 we started reporting consolidated -- there is no material difference between whether we report Pizza Hut dine in separately or delivery separately. So it's approximately similar.

I think the important differentiation is that within the dine-in business there is a delivery component and that's relatively recent. So we started delivering out of our dine-in restaurants more recently. That business is growing very nicely.

So overall on delivery profitability, we will not be commenting at this time. I think we have previously said that we regard both segments as profitable for us and we see that no reason to grow that differentially in any way. So overall I think that delivery does offer an opportunity for Pizza Hut just as it does for KFC, you seen that the growth has been quite rapid there.

On your question of value, I think we are fairly positioned. I think that Joey is looking at the business, so obviously a lot of things are being tested right now. So I hope that answers part of your question.

Joey Wat - *Yum! China Holdings, Inc. - President & COO*

Sara, to address your question on the competitive environment, the overall business, the competitive environment is quite competitive actually, I mean depending on how you look at it. One way you look at it is in casual dining... Western casual dining, we are very big compared to the rest of competitors. However, the other way to look at it is to look at the ticket average.

The ticket average of Pizza Hut is higher than KFC. And in our ticket average there are a lot of smaller competitors. Whether it's Western or Chinese they are all competitors. So that is just another way to look at it. And for potential dine-in these days in China, I would say it's probably slightly more competitive than even QSR.

In terms of your question about institutional value, what I would like to emphasize is we really are looking at the business in a holistic approach because -- I mean of course it would be very, very good to pinpoint one or two aspects. But the reality is the business has been on decline for three years. So there are quite a few key aspects of the fundamentals of the business that we need to fix.

As I mentioned in the presentation earlier, one is the product, the new product, the existing product, the service, the value for money. So all these we have to do it diligently one by one, one category by one category, one day part by one day part and we are right now on track.

Sara Senatore - *Sanford Bernstein - Analyst*

Thank you very much.

Operator

Michelle Cheng, Goldman Sachs.

Michelle Cheng - *Goldman Sachs - Analyst*

Hi, management, thanks for taking my questions. I have two questions here. Firstly on Pizza Hut, I think we are integrating the business of Pizza Hut Casual Dining and Home Service. And can you please give us some color on the cost-saving in the near term and in the longer term. I'm trying to understand whether there is some low-hanging fruit cost savings we can see to drive the margin in the next few quarters on top of those ongoing strategic initiatives. And that's my first question.

And secondly, on cost, can you also give us some color on the rental cost change including the percentage of sales and also mix between the variable and fixed components? Thank you.

Micky Pant - *Yum! China Holdings, Inc. - CEO*

Well, let me just take a top-line view, Michelle, to your two questions. On the integration of dine in and home service, obviously there will be synergies because they are appealing to the same customer at the end of the day. And instead of just 330 or so home service units now we can look at the entire estate of 2,000 units and see whether we can deliver and we are actively growing that base, so that will continue.

And as delivery grows overall you will get cost efficiencies as well. So at the moment we haven't given any data on the impact of the margins of our delivery integration and we will report that as we go along in the future. As far as rental there is no significant change. I think, as you know, we have a very significant mix of our estate is based on sales. As a percentage of sales there has been no significant change in that regard.

Joey Wat - *Yum! China Holdings, Inc. - President & COO*

Michelle, for the Pizza Hut integration, as Micky mentioned, we will go through it diligently. But one thing I just want to add is while we would like to realize some savings or benefit, we will also reinvest the savings and benefits as if -- when appropriate to build the sales for our future. So that's the additional point.

Christie Ju - *Yum! China Holdings, Inc. - VP of Finance & Head of IR*

Okay, thank you Joey. Thank you, Michelle.

Operator

(Operator Instructions). Matt McGinley, Evercore ISI.

Matt McGinley - *Evercore ISI - Analyst*

Thank you. My first question is for probably Jacky on the overall movement in the restaurant level margins. I know you only had two months of the full lap of the VAT benefit in this quarter, but the food benefit that you got in this quarter was considerably less than what you got in prior quarters and I assume that's probably chicken inflation. And yet the benefit to occupancy and other expense was considerably more than in prior quarters.

So can you give me some context as to what the overall movement drivers were of that margin in the quarter? And I guess explicitly why the occupancy was so different in this quarter versus prior quarters?

Then the second question is probably for Micky or Joey on cashless payment. I just want to make sure I understand the increase in mobile payment from quarter to quarter. I know you partner with the aggregators, but when you look at KFC year over year it only went from 8% to 10% of sales were delivery and yet you had a sequential increase in mobile payment went from I think 31% to 45%. So I'm not sure what that 2 point increase on delivery and how that translates to a 14 point increase on total mobile payments.

Micky Pant - *Yum! China Holdings, Inc. - CEO*

I will do the last one very quickly, Matt, and I will hand you back to Jacky for the question on the margin. I think it's 40% of our total revenues, total China revenues are now coming through mobile payments. So very significant of what's happening at in-store is also mobile. And actually the experience is changing very rapidly at mobile.

If you now, to China and visit a KFC you will be surprised at the number of people not standing in line but actually ordering on their phone, just like you would at an airport where you check in at a machine. And also AliPay and WeChat have been very good at extending their networks and promoting it well.

As a result of that we believe China is far ahead of anybody else in terms of mobile payment. Obviously when you pay through mobile you capture data, there is all that convenience. So the delivery has always been significantly mobile led, but now a large part of the retail dine-in experience has also been through mobile. So Jacky, on the margin.

Jacky Lo - *Yum! China Holdings, Inc. - Interim CFO, VP, Controller & Principal Accounting Officer*

Okay. Well Matt, on your first question on margins, when it comes to our margin we really try to view our business holistically and in its entirety. So we closely monitor what's happening in the competitive environment. We evaluate what our competitors are doing and we try and make sure we get the best outcome for our customers and for our brands so that we can grow our sales and sustain our margins.

So as mentioned in my comments, our restaurant margin expansion was primarily due to the VAT benefit. And as you point out, in May we began to lap the benefit so it is no longer a tailwind. As we head into the third and fourth quarters, the year-on-year margin benefit will diminish and we will be lapping a high restaurant margin.

So if you consider the commodity and labor inflations that I mentioned earlier, the margin expansion is going to have to come from our same-store sales growth. And as management we have to make this also a top priority. And we have a number of initiatives and strategies around digital and delivery as well as product innovation and value.

We also feel that our brands have pricing power should we need to take pricing. So that being said, we are committed to our long-term target of 17% restaurant margin for Yum China as a whole.

Matt McGinley - *Evercore ISI - Analyst*

Okay, thank you very much.

Operator

Annie Ling, Deutsche Bank.

Annie Ling - *Deutsche Bank - Analyst*

Hi, management team. Firstly, just following up regarding the same-store sales growth, you mentioned about like -- a question for Jackie. You mentioned about the price -- the wage increase and all these commodity price increases. So what sort of like same-store sales growth we need to offset this cost increase? Is it possible to give us a figure or a figure for KFC?

And the second question is on the share buyback. What is -- what are the criteria in considering that share buyback at like let's say for $36 or $40? And is there any particular criteria that you are looking at earnings yield or anything on that part? Thanks.

Jacky Lo - *Yum! China Holdings, Inc. - Interim CFO, VP, Controller & Principal Accounting Officer*

Okay, Anne, thank you for your questions. So, on your first questions on the level of same-store sales growth required to maintain margins, so we expect our labor inflation to continue in the high-single-digit range and commodity inflation to be in the low-single-digit. As you know, I already pointed out a couple of times in May we began to lap the VAT benefit, so it is no longer a tailwind.

But if you look at the combination of all this, in order to cover our inflation and maintain our margin, we need solid same-store sales growth. But we have not set a specific target for that because, again, we view our business holistically and in its entirety.

Once again keep in mind we have had relatively modest pricing due to the VAT benefit. So we do feel that we are competitively priced today, but we also feel that our brands have the pricing power if we want to take pricing.

And on your second question on share buyback, as I mentioned earlier, during this quarter we repurchased approximately 1 million shares for $39 million or an average price slightly above $36 and we still have $261 million remaining under our share repurchase authorization. But our plan -- I mean there is no fixed rule. But our plan is just to execute the program in the most effective way possible in future quarters.

Micky Pant - *Yum! China Holdings, Inc. - CEO*

And just a couple of color -- just to add to what Jacky has said to you. Remember, it's not as though VAT is going away. It is just that we start lapping it. So the benefit continues and obviously in a competitive market somewhere because our competitors get the same benefit. I think from the comments that Joey made earlier and Jacky made just now, you saw we have positive transaction growth so it appears that the business is growing in a healthy fashion and we have not taken pricing for a long while.

I think Joey referred to the wing bucket has been selling at the same price for four years, etc. Pizza Hut is a slightly different story but on KFC we believe there could be pricing power if needed. So overall I think that we feel quite confident about being able to grow our profit overall. But like Jackie said rightly, it's a moving -- it's a moving thing. We don't really fix so much on it. We approach it quarter by quarter to take pricing decisions accordingly.

Joey Wat - *Yum! China Holdings, Inc. - President & COO*

One last point to add I guess on the wage increase is if you look at KFC's number, the wage percentage -- while we experienced wage increase but we managed to find ways either through more inefficient procedure and process or technology to maintain the cost of labor sales ratio in the last few years it has been relatively stable. So that will help and we certainly will look at every line to find opportunities in order to maintain the margins. Thank you.

Operator

Brian Bittner, Oppenheimer.

Brian Bittner - *Oppenheimer & Co. - Analyst*

Thanks for taking the question. I have two margin questions and then I'm going to ask a follow-up on cash. On the margin questions, the first question back to Matt McGinley's question, I don't think you guys really directly answered it. What was the driver of the year-over-year improvement in the occupancy and other operating expense margin this quarter? Because I don't think any of the retail tax went into that line item. That's the first margin question.

Second margin question is you reiterated the goal to get to 17% margins. But if you hold margins flat from here for the rest of the year, you will already be at 17% margins. So the question is are you saying that your goal going forward is to just hold margins flat on a year-over-year basis from here going forward?

Micky Pant - *Yum! China Holdings, Inc. - CEO*

Brian, firstly VAT impacts every line. So it's not just related to food. It's related to occupancy, it's related to the utilities, it's related to everything. It's a comprehensive tax reform in China. Anybody gives us a VAT reform we can look for a qualified invoice we can deduct for it.

So that's a significant feature that's had an impact on all the lines. So it's not -- your understanding that occupancy is not impacted by VAT is not really true. On the -- on margin, Jacky, do you want to take the second part of the question?

Jacky Lo - *Yum! China Holdings, Inc. - Interim CFO, VP, Controller & Principal Accounting Officer*

Yes, the second question is on the long-term -- the restaurant margin target. So again, going into the second half of the year, the year-on-year revenue margin benefit will diminish, as I pointed out a couple of times. So we will be lapping a high restaurant margin going forward.

But I mean like I said earlier, the VAT benefit is not going away. We have already reached this around 16% range with the restaurant margin, but our long-term target is still 17%. So going forward we still have to work on our same-store sales growth to get to that point.

Micky Pant - *Yum! China Holdings, Inc. - CEO*

I think overall margins have been very healthy right since May of last year. So as we go into this year we've got the [assure] -- continued growth in margin becomes more challenging because you don't have the lapping VAT benefit. But we have -- if it does settles at a higher level and now we have to see where...

Brian Bittner - *Oppenheimer & Co. - Analyst*

I understand VAT does not go away. I fully comprehend that. Are you expecting the margins to decline in the second half? Because what I'm trying to say is if the margins are flat in the second half, you have 17% margins this year if they are flat. So I guess -- because I think it's good to have the expectation out there so everybody understands.

Are we expecting margins to decline year over year now that we are not getting that tailwind in the second half? Because if they don't then we will have 17% margins this year already and you will be at your target is kind of what I'm saying.

Christie Ju - *Yum! China Holdings, Inc. - VP of Finance & Head of IR*

Brian, it's Christie here. I understand your question. We are definitely not guiding the near-term margins on quarter-to-quarter or half-to-half. The 17% is our longer-term target for restaurant margin. And just to be fair, compared with across the industry we believe 17%, once we achieve it, it will be a very healthy target already. We are not providing additional guidance in terms of the margins.

All we are saying is we are confident with the double-digit operating profit growth. I think that once we achieve that 17% longer-term target, obviously we want to be able to achieve it sooner rather than later. We think we can look at it or go and make additional adjustment.

But what's important at this point of time, as we highlighted by management, is that keep in mind Pizza Hut is still in the turnaround period. At this time I think what we are focusing on is really to drive sales. And we have all the confidence then once the sales is revitalized the margin will follow.

So again, just to be very clear, we are not providing second half margin guidance at this time and we are confident that as long as we continue to push forward as the priorities the margin will follow.

Brian Bittner - *Oppenheimer & Co. - Analyst*

Got it. Okay, thanks.

Operator

Christine Peng, UBS.

Christine Peng - *UBS - Analyst*

Time management. I have two quick questions. One is for Pizza Hut. Can you provide us a breakdown of same-store sales growth between traffic and ticket value?

Second question is for Jackie. The cost pressures you mentioned in second quarter is actually not very different from the first quarter. However, if we look at the full market prices for a lot of commodities, especially like chicken, actually in second quarter chicken prices have fallen quite dramatically compared with first quarter.

The reason the cost pressure consisted -- keeps almost the same level in the second quarter, is that because of inventory? And looking in the second half of the year, what is the expectation towards chicken price on a year-on-year basis for Yum China? Thank you.

Micky Pant - *Yum! China Holdings, Inc. - CEO*

Okay, so Joey can answer Pizza Hut's traffic question and Jacky can address the commodity issue.

Joey Wat - *Yum! China Holdings, Inc. - President & COO*

Christine, for Pizza Hut, right now we are running a 1% increase on transaction and 1% decline in ticket average. As we are going through the product review we certainly focus on good new products and good value for money. So, going forward the focus will still be more on getting more customers into the store. I guess that's it and go to Jacky.

Micky Pant - *Yum! China Holdings, Inc. - CEO*

Jacky, before you start, just quickly, Christine since you follow the Company so closely, you picked up from Joey, right, that the traffic growth in KFC was plus 3, on Pizza Hut it was plus 1. Now I think Joey is absolutely right in cautioning that while that's good and we are happy with those numbers, just remember that as delivery grows it puts pressure on traffic because -- or transactions rather.

Total number of customers may increase, but the average ticket per transaction grows a lot. Plus as we sell buckets during holidays, etc., and the bucket mix is increasing, that also has an impact. So it's kind of a parsed out number, but overall numbers were plus 3 and plus 1.

Joey Wat - *Yum! China Holdings, Inc. - President & COO*

Thank you, Micky. Actually the dynamic is different for the two businesses. So I just want to take the opportunity maybe to talk a little bit about it because for KFC the more delivery we do the lower ticket average -- sorry, the higher ticket average we have the lower ticket PC we have, because the average TA for -- ticket average for KFC is much higher delivery than dine in.

However, for Pizza Hut it's the reverse. So just bear that in mind when you look at the business because the more delivery we drive in Pizza Hut actually the lower ticket average we have.

Jacky Lo - *Yum! China Holdings, Inc. - Interim CFO, VP, Controller & Principal Accounting Officer*

And Christine, on your second question on the commodity price or specifically chicken price, our commodity inflation was 4% during the second quarter and the rate peaked at 4.5% in the first quarter. It came down to 4% in the second quarter and we expect it to continue to moderate throughout the rest of the year.

So, we have finalized purchasing contracts for roughly about 90% of our full-year spend and at this time we expect commodity inflation to be low-single-digit percentage for the full year.

Christie Ju - *Yum! China Holdings, Inc. - VP of Finance & Head of IR*

Thank you. Can we take the last question, please?

Operator

Annie Ling, Deutsche Bank.

Annie Ling - *Deutsche Bank - Analyst*

Hi, regarding the effective tax rate, I've noticed that there is some volatility by quarter. And I just wanted to check, what is our full-year guidance? I think around listing time we mentioned about the effective tax rate around 27% or 28% to 30%, correct me if I am wrong. And so, what is -- is there any guidance for the full year? And for this guidance, does that include also the potential like withholding tax if we are paying dividend or this is actually excluding that?

Jacky Lo - *Yum! China Holdings, Inc. - Interim CFO, VP, Controller & Principal Accounting Officer*

Okay, Annie. On your questions, so for Q2, yes, the effective tax rate was a little bit higher than last quarter -- last year's Q2. And keep in mind, we were still part of Yum this time last year. So our tax rate in Q2 2016 was related to Yum's global tax strategy. But for the full year in 2017 we maintain our guidance of an effective tax rate in the high 20s. And that will reflect all the withholding tax that you just mentioned.

Annie Ling - *Deutsche Bank - Analyst*

Okay, thanks.

Operator

There are no further questions at this time. I would now like to hand the conference back to today's presenters for some closing remarks.

Christie Ju - *Yum! China Holdings, Inc. - VP of Finance & Head of IR*

I think -- thank you, everyone, for participating to the call. I also thank the team and for a lot of interesting questions. If you have any follow-up, feel free to contact us. That's it for now. Thank you very much.

Micky Pant - *Yum! China Holdings, Inc. - CEO*

Thank you, everyone. Bye-bye.

Operator

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