REFINITIV STREETEVENTS

EDITED TRANSCRIPT

Q3 2020 Yum China Holdings Inc Earnings Call

EVENT DATE/TIME: OCTOBER 29, 2020 / 12:00AM GMT

CORPORATE PARTICIPANTS

Debbie Ding *Yum China Holdings, Inc. - Senior IR Manager*
Joey Wat *Yum China Holdings, Inc. - CEO & Director*
Ka Wai Yeung *Yum China Holdings, Inc. - CFO*

CONFERENCE CALL PARTICIPANTS

Brian John Bittner *Oppenheimer & Co. Inc., Research Division - MD and Senior Analyst*
Chen Luo *BofA Merrill Lynch, Research Division - MD*
Kin Shun Ling *Jefferies LLC, Research Division - Equity Analyst*
Lillian Lou *Morgan Stanley, Research Division - Executive Director*
Linda Huang *Macquarie Research - Head of Hong Kong & China Consumer Research and Chinese Consumer Analyst*
Michelle Cheng *Goldman Sachs Group, Inc., Research Division - Executive Director*
Sijie Lin *China International Capital Corporation Limited, Research Division - Associate*
Xiaopo Wei *Citigroup Inc. Exchange Research - Research Analyst*
Yan Peng *UBS Investment Bank, Research Division - Executive Director and China Consumer Staples Sector Analyst*

PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to Yum China 2020 Third Quarter Earnings Conference Call. (Operator Instructions) I must advise you that this conference is being recorded.

I would now like to hand the conference over to your speaker today, Ms. Debbie Ding. Thank you. Please go ahead.

Debbie Ding ***Yum China Holdings, Inc. - Senior IR Manager***

Thank you, operator. Hello, everyone, and thank you for joining Yum China Third Quarter 2020 Earnings Conference Call. Joining us on today's call are our CEO, Ms. Joey Wat; and our CFO, Mr. Andy Yeung.

Before we get started, I'd like to remind you that our earnings call and investor presentation contains forward-looking statements, which are subject to future events and uncertainties. Our actual results may differ materially from these forward-looking statements. All forward-looking statements should be considered in conjunction with the cautionary statement in our earnings release and the risk factors included in our filings with the SEC.

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

Today's call includes 3 sections. First, Joey will provide an update regarding recent developments, then she will offer some highlights around our quarterly results. Andy will then cover the financial results and provide an update on our full year outlook. Finally, we will open the call to questions.

You can find the webcast of this call and a PowerPoint presentation, which contains operational and financial information for the quarter, on our IR website.

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

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

Thank you, Debbie. Hello, everyone, and thank you for joining us today. As I reflect on this challenging period, I want to thank our employees, our customers, our partners and our shareholders for your continued trust in Yum China.

Resilience is only proven when tested, and we certainly were tested. Following 2 challenging quarters, we delivered system sales growth for the third quarter. This is the result of the tireless dedication of our staff and partners, working to safely provide good food, great value and convenience for customers across our 10,000-plus stores.

Hold fast, stay true. Throughout the COVID pandemic, we hold to our key operating disciplines. Food safety, employee care and customers focus guide our actions. In over 1,400 cities we operate, we provide employment, career progression and a commitment to improving our local communities. We stay true to our culture of innovation, building on our leadership in digital and delivery. All these adds to the resilience of Yum China.

We achieved much in 2020 despite the COVID challenges. First, we opened our 10,000th store this quarter, marking a significant milestone. Secondly, our brand demonstrates innovation and execution excellence, capturing the shift to off-premise dining early. KFC and Pizza Hut pioneered contactless delivery in late January. We engaged with over 20,000 companies regarding corporate delivery, tapping into another segment of new customers. Pizza Hut celebrated its 30th anniversary by driving menu innovation, improving its takeaway and individual set offering. Third, we formed a joint venture with Lavazza and opened the first flagship coffee shop in Asia. We will continue the journey together to explore the China coffee market. Fourth, we completed the acquisition of Huang Ji Huang and formed a Chinese dining business unit to tap the massive Chinese cuisine market opportunity. Last, but not least, we list on the Hong Kong Stock Exchange in September, becoming the first Delaware incorporated company to list on both NYSE and Hong Kong Exchange. This listing, in one of the most vibrant trading markets in Asia, bring investors closer to our consumers and partners. At the same time, we maintained our strong corporate governance and discipline.

The Yum China of the future will have a much larger footprint across China. Stores will remain new or freshly remodeled. We will continue to serve innovative food across day parts and occasions. Our portfolio of brands, built organically and through a disciplined M&A process, will target strong growth segments. This will be supported by key infrastructure, whether in supply chain, logistics or digital marketing. We are committed to investing in this future. A future of market leadership, enabled by growth in stores, growth in our portfolio and growth in digital and membership capabilities.

Let me elaborate on each of these growth initiatives. Firstly, store growth. It took us over 15 years to open the first 1,000 stores. In the last 4 quarters, we opened over 1,000 stores as well. We have the capability, infrastructure and proven store models to build profitable new stores at scale. Importantly, as delivery and takeaway become more popular, we are adapting our new stores to smaller sizes and lower CapEx. Increasing store density gets us closer to our customers, serving them faster and better while capturing incremental sales and profits. We are piloting store models, which are tailored for lower-tier cities to penetrate new markets with greater flexibility and efficiency.

Localized menus, store layout and operating models enable us to serve a more value-cautious customer. China is a large, diverse market with regional differences in economic development and policy. We will adopt region-specific strategies to create the flexibility and pursue accelerated growth trends regionally. Multiple channels, different models and regional strategies are crucial to expansion, enable us to develop a strong franchisee network. Market leadership will also require investments in our infrastructure from more logistics centers to IT solutions. We will need to strategically deploy capital for both off-line and online assets, future-proofing our leadership as we build the next 10,000 stores.

Secondly, portfolio growth. We are proud to welcome the Huang Ji Huang and Lavazza brands to our Yum China family this year. In addition to our core Western Dining brands, Chinese dining and coffee represent exciting new segments for growth.

Over the past few months, we have found opportunities to collaborate between our Little Sheep and Huang Ji Huang brands in areas of franchisee development, seasoning distribution and supply chain. Huang Ji Huang franchise partners are already leveraging Yum China's strong delivery capabilities to improve store economics, and we are excited for further synergies.

Similarly, leveraging our COFFii & JOY experience, our partnership with Lavazza has seen early success. The 3 Lavazza stores in Shanghai are receiving great customer feedback. Yum China's capabilities in digital, data and delivery are creating an ecosystem for our consumers and will drive growth across our portfolio of brands.

The third growth initiative is in digital and membership. Last quarter, we shared some of our thinking around digital memberships and their importance as a growth driver. We will invest in creating a customer-centric digital marketing platform. Additionally, end-to-end digitization and the application of AI technologies are vital. From farm to fork, our goal is to track, analyze and automate across our value chain. From receiving of goods to real-time control of inventories and operations, investments in digitization empower us to improve operational efficiency and drive customer satisfaction. Crucially, this will give us added confidence to accelerate working with our franchisee partners and reach further into more -- remote areas. Strong digital and membership programs create synergies within our portfolio of brands. This improves unit economics, in turn, driving store growth.

All of these growth initiatives are interdependent. Investments across all 3 are necessary to build on our leadership and agility.

Now a few observations from this quarter. KFC sales demonstrated improvement in the third quarter, supported by our value campaigns and digital initiatives. Domestic tourist and transportation hub volume slowly recovered, but international travel and tourism is still weak.

Pizza Hut continued to make great progress with new offerings, refreshed restaurants and strong execution capabilities. Pizza Hut recovered sales to 93% of prior year period. Our actions across the pillars of revitalization continue to bear fruit as ticket average improved sequentially.

Restaurant margins improved by over 5 percentage points, and operating profit grew 59% year-over-year in constant currency. Value for money is important to consumers during this difficult period. Across our brands, we ensured a strong value proposition. KFC extended Crazy Thursday to Wednesday and Friday. Pizza Hut brought back the hugely popular, All You Can Eat program in September.

Apart from great value, our innovative products excite customers. At the national level, we launched the Durian Chicken Burger at KFC and the Chinese-style braised beef and pizza, Dongpo (foreign language) at Pizza Hut. We also trialed regional flavors in selected markets, such as Wuhan hot dry noodles, Wu Han Re Gan Mian and late night delivery of Sichuan spicy crayfish, Sichuan Ma La Xiao Long Xia.

Delivery drove strong growth across our entire portfolio, accounting for approximately 28% of sales in the third quarter. We continued improving our takeaway menu and offers to complement delivery. Together, off-premise mainly accounts for over 55% of sales at KFC and 40% of Pizza Hut. Digital orders were 78% of sales, well above pre-COVID levels, fueled by digital members grew to over 285 million. During the quarter, we sold 19 million Privilege memberships at KFC and Pizza Hut, covering multiple categories, other than the signature delivery and family privileges. We sold over 8 million chicken lover membership -- in Chinese, we call it Wang Zha Ka, at KFC during the summer holiday. This pay membership tripled frequency and sales per member during the subscription period. We generated meaningful profit in this quarter. Despite the pressure from sales deleveraging, our $320 million of operating profit, excluding special items, was the result of the strong efficiency improvement we have made.

As we look forward to the end of the year and into 2021, we remain cautiously optimistic. We must continue to be vigilant and agile. I need to remind our stakeholders that China is a large diverse market, and regions will experience varying levels of COVID impact until the new vaccines are developed. The recovery will continue to be nonlinear and uneven, but we are well positioned to navigate these uncertain times.

With that, I will hand over the call to our CFO, Andy Yeung. Andy?

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

Thank you, Joey, and hello, everyone. I will first address key financials and development in the third quarter, then provide some color on our outlook. Unless noted otherwise, figures mentioned refer to the third quarter of 2020. All percentage changes are before the effects of foreign exchange.

Revenue was flat year-over-year with same-store sales recovered to 94% of the prior year period. All brands have sequential improvement in sales. This is a testament to the hard work and dedication of our employees to drive top line in the challenging environment.

KFC same-store sales recovered to 94% of the prior year period, compared to 90% in the second quarter and 89% in the first quarter. Improvement was largely driven by effective value promotions and digital initiatives. Same-store traffic recovered to 90% from 80% in the second quarter. Our transportations and tourist hub sales improved, but still remain under pressure.

Pizza Hut same-store sales recovered to 93% of the prior year compared to 88% in the second quarter and 69% in the first quarter. Value campaign, all you can eat and membership initiatives were effective in driving traffic and ticket average. Overall, dine-in volumes recovered to over 80% of prior year for our core brands.

Strong contribution from delivery and takeaway continued with over 50% of our sales being off-premise. The consolidations of Huang Ji Huang contributed 3% to total system sales in the quarter. Together with the consolidation of Suzhou KFC, their contribution to total revenues was 2%.

We opened 312 stores. New build accelerated as our development team secured favorable locations with more flexible store format also helping expansion.

Despite the same-store sales decline, restaurant margins were 18.6%, up 0.9% compared to last year. Sales deleveraging was more than offset by our aggressive efforts to control costs and improve operational efficiencies.

Cost of sales was 31.2%, almost flat year-over-year. This was largely driven by a 1.7% reduction at Pizza Hut as they lap aggressive promotion made last year. KFC has a 0.7% increase in cost of sales. The impact of more aggressive promotions and value campaigns to drive store traffic and sales was partially offset by commodity deflation of 1% at KFC.

In particular, we work closely with our major poulty suppliers to take advantage of a more benign inflation environment.

Cost of labor was 21.6%, almost flat year-over-year. Wage inflation was 3%. It was subdued in many of our markets as government-mandated minimum wage increase were deferred. Labor productivity improvement has largely offset the impact of wage inflation and increase in delivery rider costs. Labor productivity improvement was accentuated by shortage of part-time workers in the quarter. We intend to increase staffing levels in the coming months to balance service and efficiency.

Compared to $40 million in the first quarter and $50 million in the second quarter, we received approximately $10 million in rent reductions and government relief. However, we expect this to phase out.

G&A expenses increased 6%, mainly due to a lapping of prior year's government incentives and impact of consolidating G&A expenses at Huang Ji Huang and Suzhou KFC. Excluding the impact of consolidation, year-to-date, G&A expenses decreased 1% year-on-year.

We achieved operating profit of $556 million, including a remeasurement gain of our existing equity stake in Suzhou KFC of approximately $239 million. Excluding special items, such as remeasurement gain, adjusted operating profit was $320 million, representing a year-over-year growth of 5%.

Our effective tax rate was 25.6%.

Net income was $439 million, and adjusted net income was $263 million. If we exclude $29 million net investment gain in Meituan, it will be $234 million, up 8% year-on-year.

Diluted EPS was $1.10, and adjusted diluted EPS was $0.66.

I would like to touch on our capital allocation strategy. Following a careful review of our financial position, we will resume our cash dividends at $0.12 in the fourth quarter. Our capital allocation focuses on driving the long-term growth of Yum China while providing adequate liquidity to navigate any sudden disruption to our business.

With the capital raised in our secondary listing in Hong Kong, we will focus on: one, accelerating new build and maintaining store remodeling across the Yum China portfolio; two, stepping up investments in our digital, logistics and delivery infrastructures to support and drive growth; three, maintain a disciplined approach to M&A and investments while exploring opportunities to invest in brands with excellent growth opportunities, new capacities and technologies.

As this year has shown, having sufficient liquidity is paramount to operating in an uncertain environment. Our strong balance sheet provide us the capacity to deal with potential contingencies while allowing us to make targeted investments to drive growth and capture market opportunities. We believe this approach to capital planning will drive long-term shareholder returns.

In terms of outlook, as we look ahead to the fourth quarter, we are encouraged by sequential quarterly improvement. However, we must be mindful that the pandemic is still not over yet. The remaining journey to recovery is going to be challenging. We expect our store traffic and sales continue to be impacted by: one, the lingering effect of COVID-19 on consumer behavior; two, transportation and tourist volume, while recovering, continue to be heavily impacted; three, additional precautionary measure that consumer and/or government may take as we enter the colder months and as flu season approach.

At the same time, we also expect margins to be impacted by sales deleveraging and a continued focus on value campaigns to drive store traffic, phasing out of COVID-19-related relief, increased staffing levels to balance services and efficiencies and finally, store impairment review, factoring in the impact of COVID-19.

It is important to note that the fourth quarter is not only seasonally the lowest quarter for sales, but also the biggest quarter for store remodeling. Small changes in operating results or investments can have a significant percentage impact on operating profit.

In terms of inflation outlook for 2020, we now expect wage inflation to be low to mid-single digits, commodity inflation to be flat to low single digit, driven by lower poultry prices. In terms of store opening, including Huang Ji Huang, we now target to open more than 900 new stores. As a reminder, following our secondary listing, we ended the third quarter with 419 million shares outstanding.

As for 2021, we are operating under the new normal of reduced travel and social activity. Sales momentum will continue to be impacted until the pandemic is over. With bouts the COVID-related disruptions, different regional markets will likely experience varying performance.

In October, there were regional outbreaks in Qingdao and Western China, which resulted in testing for millions of people. This is a good reminder that the recovery will be nonlinear and uneven.

We continue to face cost pressures on multiple fronts. As part of our commitment to the environment, we will begin to phase out the use of plastic packaging. This is expected to materially increase our cost of sales.

Wage increases have been mostly deferred or delayed in 2020. We expect this to catch up.

We will also step up investment to build out our digital logistics and delivery infrastructure. Accelerating investment in these areas will be critical in maintaining our market leadership.

With our digital infrastructure, solid execution and strong balance sheet, we are prepared to capture opportunities for recovery and growth. We will provide additional details on specific 2021 target with our Q4 earnings release in early 2021.

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

Debbie Ding ***Yum China Holdings, Inc. - Senior IR Manager***

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question comes from the line of Sijie Lin from CICC.

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

Congratulations on the good performance. So I can ask 1 question, right? My question is on Pizza Hut. Because for Q3, we see that the near 17% of restaurant margin is really a high level even through its history. So could we know more about what happened behind this? And is it sustainable looking forward?

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

Thanks. this is Andy. So I will address your question regarding margins at Pizza Hut. I think overall margins, if you look at the overall margin for the quarter, we do have very strong performance on both KFC and Pizza Hut. Overall, if you look at Pizza Hut, for example, certainly, we are still impacted by sales deleveraging, roughly more than 2%.

For inflation, we do see continuing commodity pressure, pricing pressures for the cost of sales. But that's more than offset by the late productivity improvement. Now if we look down at each cost item, if we look at, for example, cost of sales, we see that this is improvement about almost like 1.7%. The main part of that is commodity inflations is offset by lapping of promotions in 2019.

Now for cost of labor, we see about 1.4% improvement. Despite sales deleveraging, wage inflation, we see that labor productivity gain (inaudible), as I mentioned on the prepared remarks, is accentuated by the shortage of part-time worker this quarter. And so -- and also, we also benefit a little bit from the lower social insurance contribution.

The big improvement here is actually on what we call O&O, and that had a lot do with a number of cost initiatives at the restaurant level, including utilities, maintenance costs. We also got some rental relief, of course.

Operator

And your next question comes from the line of Brian Bittner from Oppenheimer.

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

Congratulations on navigating this environment. Your unit growth outlook for 2020 continues to be very strong despite the pandemic. Are you able to give us a look into the pipeline for 2021? Or give us any color on how you're starting to think about the unit growth opportunity in 2021?

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

Brian, this is Andy. So I would give you some color, and then Joey may want to feel free to jump in later. I think, as we mentioned, we -- at the beginning of the year, first half this year, we certainly have a little impact from COVID-19 in terms of our store opening. As we have mentioned in the prior earnings call, our development teams have a lot of projects in the pipeline at the time. But obviously, because of the pandemic, there was some delay in construction because the limited mobility in March, April time frame. So they have been trying to catch up, obviously. So -- and they have done a pretty good job this quarter. We -- that's why we're confident that we can meet the target and raise that to -- from Q3, we guided to about 800 to 850 stores to now more than 900 stores. As we have mentioned, as Joey mentioned, our next milestone would be another 10,000 stores. It took us quite a while to get to the first 10,000, it was almost 33 years. We certainly think that we will do it much faster this time around.

In terms of the pipeline for 2021, I think right now, we're still in the planning process. It is too early to provide you that information. But we would give more details in our planning. However, but if you look at our current situation right now, we do think that we still have a lot of opportunities in China for growth for store network expansion. If you look at the number of cities that we are in right now, it's a little bit more than 1,400 for KFC and I think 800-plus in -- for Pizza Hut.

So we're still tracking about probably close to 500, 600 or more cities that we can penetrate in the future. So those are the white space.

Also in terms of increasing penetration in the top tier cities. I think -- and also lower tier cities, we think there's also a lot of opportunity as well. Looking at store density, compared to -- not only to North America, but also to other Asian countries and regions, our store density is still relatively low. So particularly with the shift to a smaller store format and also with catering more to delivery and takeaway, I think we do have a lot more opportunities in terms of increasing the penetrations of our store network in the existing market that we're in right now. Hopefully, I addressed your question.

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

Thank you Andy. Brian, I would just like to add 3 comments on your question. One is we always emphasize on the quality of stores. So we will be aggressive and open mind about new stores if we see opportunity of opening good stores, profitable store, or at least breaking even stores. So that's the bottom line, we hold very, very close to our heart. And thus, bottom line, the bottom-up approach is if we find those, we'll open them.

Second is, as Andy mentioned earlier, I just want to get more specific is at the Tier 1 city -- Tier 1, Tier 2 city, we are going for smaller stores to adjust our store portfolio strategy because the growth of delivery and takeaway and also to handle the rent and other costs as well. And it's quite an efficient model to fill in the gap of the trade zone. For the lower-tier cities, we have been working on the lower-tier city store models. And this year, we have further breakthrough in our models, not only the investment cost for the lower-tier city model is getting even lower, we find innovations to do that, but also, we have customized menus for the lower-tier city.

To give you an example, we have opened a few such stores this year. We feature something called Crazy Store Manager offer, which will feature a combo, a lunch set of RMB 15, which is a bit more than $2, and our normal combo for 4 items in Tier 1, Tier 2 city would be $30 to $35, et cetera. So you see the gap. And the products are different. We are not going to sell the same product at such big price gap. But the lower-tier city in some -- particularly in the western and the northern parts of China, require a different understanding of our menu.

Point 3, Pizza Hut. We have been talking about the satellite store model since last year, and we've been working on it because essentially, what the satellite store means is huge reduction in terms of CapEx investment and quite a different store operating model. For example, our kitchen needs to move from 140 square meter to a much smaller size, cut it by half, per se. And the menu is slightly different, too. And as of this year, we are going to have about more than 20 satellite stores. And I will -- I'll be happy to say that the initial results are encouraging, and we are happy to see what we are seeing right now for both satellite store, for Pizza Hut and for the lower-tier city stores for KFC. Thank you, Brian.

Operator

And your next question comes from the line of Linda Huang from Macquarie.

Linda Huang ***Macquarie Research - Head of Hong Kong & China Consumer Research and Chinese Consumer Analyst***

I have 1 question regarding for the store expansion. Because I noticed that the payback period, especially for the Pizza Hut, slightly increased. Before, I think payback period is 3 to 4 years, but right now let's say 2 to 5 years. So I just want to know that whether in the future, we continue to expand the store. And do we worry about operational efficiency issue? And can you also share with us about Huang Ji Huang, its payback period?

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

Linda, so let me address the Huang Ji Huang and then I get back to the earlier part of that. For Huang Ji Huang, it's mostly a franchise model. So almost all the store -- large majority of the store are franchise model. That same goes for Little Sheep. And so in terms of payback period, it's not very meaningful for us. And especially with the franchisees, but what we can say is that the franchisees themselves actually relatively happy with their payback, and that's why we continue to see pretty decent build out in terms of the franchise operations over there.

The -- hold on a second. What's the question?

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

It's the payback period for Pizza Hut. Linda, for the Pizza Hut payback period, I think because of the COVID-19 and the way that we calculate number is a rolling number, so of course, during Q1, Q2, it impact our payback period a little bit. But we still overall are confident with the overall trend of the payback period of Pizza Hut. Particularly with the innovation on satellite store, we are quite happy to see what we are seeing right now in Pizza Hut. Thank you. Andy?

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

Right, right. So Linda, so I just want to remind folks that when we disclose the payback period, generally, we are using actual number. So they will reflect the impact on the recent month, which is, I guess, Joey mentioned, impacted by COVID-19, right? So -- but overall, I think if you look at the store recovery in terms of the sales recovery, we're on a -- I think, the right direction. Overall, if you look at SSG, it's back to 94% for KFC and then 93% for Pizza Hut. And so in that sense, I think we may still seeing that lowering average being impacted, but that should -- and fundamentally, we haven't seen a material change in terms of how our stores are performing and then also in terms of longer-term outlook, I think as to the recovery, even though it's going to be nonlinear and uneven. But I think eventually, the pandemic will be over. And then I think we are comfortable that we will not fundamentally change our store economics.

Obviously, there were some operational changes in terms of how our store, as Joey mentioned, we would continue to experiment with different store format. And for Pizza Hut, for example, we also have this satellite store format are being rolled out. So it would -- but nevertheless, I think the fundamentals haven't changed, maybe more delivery, more takeaway in terms of sales, smaller store format going forward. But I think we haven't changed our view on the payback in the future.

Operator

And your next question comes from the line of Xiaopo Wei from Citigroup.

Xiaopo Wei ***Citigroup Inc. Exchange Research - Research Analyst***

Congratulations again for the strong recovery in the third quarter. So we are now in fourth quarter, which is a low season. I will be more interested in upcoming 1Q next year, which is a peak season. In my view, that is Joey and team may have to face in tougher choices next year first quarter because, on one hand, you have to be more proactive in terms of recovery sales further. On the other hand, you have to hedge against any risk of disruption due to any coming back of the COVID cases. So like Chinese saying, Yi Ke Hong Xing,Liang Shou Zhun Bei. So how could you balance the 2 with your strategy, operation, i.e., in terms of innovation, value campaigns, delivery and menu offering, et cetera?

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

Thank you, thank you, Xiaopo. That's a good way to put it on Liang Shou Zhun Bei. In fact, that's exactly sort of our approach for this particular year since January, the happening of COVID-19. How are we going to do that for 2021? It's not going to be too different in terms of the general approach. We will be prepared, we'll be agile, we'll be flexible, and we'll be cautious, but we'll also be optimistic.

If we look at particularly Q3 this year, all of our brand improved in terms of SSSG, the dine-in actually continue to recover. But we also work very hard on strong value campaigns to drive traffic for both KFC and Pizza Hut. But at the same time, we are very well aware of the lingering effect of outbreak. And thus, our repeat caution to our investors and analysts about the uncertainties of COVID-19, we just have to live with it, really.

But when we come to the business, we still have to focus on each core pillars of the business, and we have to make sure each pillar is strong and sound and agile and flexible because we are in a very good position to manage all the challenges and actually still achieve innovations and result for our shareholders, for our customers and for our employees.

And if we just recap what, let's say, KFC and then Pizza Hut, what happened here for Q3 or for this year so far, as I mentioned earlier, we focus on the value promotion, LTO, the new product. And then we focus on the privilege subscription. So our membership throughout the COVID-19, particularly during the most difficult times, when we actually could not do advertisement very effectively, we actually could focus on our membership to still launch new product, conduct marketing campaign.

And on top of the pillar of the membership, we work on our delivery. And our delivery improved, continued to grow with double-digit growth for Q3, Q2 and Q1. So delivery is very agile and resilient business. And transportation hub and tourists is still being challenged. The sales is still below pre-outbreak period. It's still about 20% less. But we continue to work on it.

And then the regional differences. Regional differences also means regional opportunities, too. The Eastern China is still better than Northern China. The lower-tier city is still better than higher-tier city. And then the recovery in weekend and weekday, right now it's even out. But in the past, we were doing a bit more promotion in weekday, a bit less in weekend because our weekend traffic was quite stable, quite encouraging and vibrant. But COVID-19, the weekend traffic is -- the pattern changed. But it's okay. We make ourselves more agile and flexible, and we learn better way how to deal with the weekend and weekday traffic recovery. And then -- that's the KFC.

And for the Pizza Hut, despite the COVID-19, we still fulfill our promise of sales first and profit later, which we have been talking about for a few years now. And we have seen progress in the menu, the value campaign, the perception of value and expanding takeaway channel. And thus, by Q3, we've recovered our sales to 93% and driven, not only due to the improvement in traffic, but ticket average. And how did we do that? Less discounting -- well, actually, more targeted discount marketing campaign, increased party size and all you can eat.

So all in all, with our flexibility and with our focus on each of the pillars driving the business, I think we have demonstrated our resilience for 2020. And I would like to believe our resilience and our team's ability to deliver during a very difficult time of 2020, we shall continue to do that for 2021. Thank you, Xiaopo.

Operator

And your next question comes from the line of Chen Luo from Bank of America.

Chen Luo ***BofA Merrill Lynch, Research Division - MD***

And also congratulations again on the strong Q3 results. So got a question on Pizza Hut, which actually offer a quite big upside surprise for Q3. But typically in the past, same-store sales growth for Pizza Hut should be weaker than KFC. But this time, Pizza Hut was quite close to that of KFC, and the pace of Pizza Hut recovery also seems to be faster. What's the reason behind that? Is this because of all the measures that we have taken to revitalize Pizza Hut? Or it is also partly because of the assumption that maybe casual dining in China is actually recovering at a faster pace for the industry as a whole?

And also with regard to margin, the food and paper cost as a percentage of sales declined quite dramatically for Pizza Hut, even if we are -- and at the same time, we are getting less promotional than last year. If that is the case, how should we reconcile that with encouraging same-store sales growth trends for Pizza Hut in Q3?

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

Let me make you comment on the sales recovery side, and then Andy can address Luo Chen's question on margin. I would say your thought about the Pizza Hut recovery is due to the overall model recovery. Overall business recovery is what I agree and what we believe, and that's what we've been working on. And we have been -- as I mentioned earlier, we've been talking about our focus, our promise of sales first and profit later for Pizza Hut for a few years now. Actually, Pizza Hut 2019, we delivered the first recovery of traffic, particularly the dine-in traffic which was very, very critical for our business because before 2019, the last time we had positive traffic growth in Pizza Hut dine-in business, in particular, was back in 2014. So '15, '16, '17, '18, it was hard work. And by 2019, we get our customers, and that's the most, most important part of the improvement.

And we have been also talking about a few pillars of the revitalization. The menu, we changed 70% of the menu. So the food is very, very different. The delivery, we rebuilt our delivery team. We took it in-house. It was painful. But we got it done without impacting the sales growth or the margin. We worked on the perception of value to pay service level, dine-in environment. I don't know whether it's clear to our stakeholders, but we actually had the commitment for Pizza Hut for not increasing the price for 3 years. No price increasing for 3 years is a very strong commitment to bring back the value for money, which is absolutely critical for a Pizza Hut business model.

And during the COVID-19, we also look at it as a -- well, of course, it's a challenge, but it's also a trigger point to do even more innovation in takeaway because we were building the system before the self-order, mobile order system before that. And we launched in a big way, and the takeaway business took off. So that's added another leg to our business.

So it's not due to 1 or 2 things, it's due to many things that we have been doing. All the key pillars of the transformation are delivering the result. Thus, we are quite pleased to see the progress. And I'm certainly quite proud of our team's hard work that producing the result right now. And we do believe that the fundamental change and improvement of the business model will continue to help Pizza Hut's deliver ongoing improvement.

It's not done yet. We are still working on the breakfast day part, for example, because it's still an opportunity for us as well. But that's just ongoing. With that, I'll pass the question to Andy to give some color about the margin question for Luo Chen.

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

Sure. Thanks, Joey. And then actually, I want to supplement your comment a little bit. I think it's important for us to put things in perspective. I think KFC actually have improved quite well in terms of SSG. Last quarter, they had SSG of about 90. And this quarter, they're about 94. If you look at Pizza Hut, last quarter, their SSG was 88. And obviously, we're pleased that they're at 93 now. So both brands have actually seen quite a bit of improvement in the same store growth recovery.

And more importantly, I think if we look at the impact in the third quarter, for example, at the beginning of the third quarter, we will still have an impact from regional outbreak in Beijing. And then we're also further impacted by, obviously, the strong school holiday. So in light of that, I think we are pretty pleased with both brand trajectory at this time.

Obviously, as we mentioned before, the recovery pace, as we get closer and closer to full recovery, it's going to be more challenging. The reason is because we still are not out of the woods. So if you look at transportation and tourist location, as Joey mentioned, is still down quite a bit, right, more than 20% in terms of traffic over there. And those are important part of our business, account for high single-digit of our business.

If we look further a little bit more, we still have some improvement to do at the dine-in business, right? The traffic at our store right now is 90% of last year's level. So getting -- the last group of people to feel comfortable and venture out in dining, may take a little bit more time. And we -- so we -- that's why we say like we feel pretty good about the third quarter results, but we are cautiously optimistic in the fourth quarter. And the emphasis is in the cautious bit -- especially as we go into the winter season and the winter flu season. So there, we should expect some potential regional outbreak or additional measures that will be taken by consumer or government as time goes by.

In terms of margins, I think if we look at the overall margins, especially at Pizza Hut, I think they, obviously, as Joey mentioned, our strategy has always been to fix the fundamental, to drive traffic and sales and then profitability. This is obviously a little bit unusual and extraordinary in the sense that we -- at the beginning of the year, we've seen a very significant decline in sales due to COVID-19, and we are very glad that Pizza Hut team take a very quick actions in terms of cost savings as well as building new products for the situation.

So when we look at cost of sales, for example, overall for Pizza Hut, as I mentioned, it's about like 1.7% better. And we're still under some inflationary pressure in terms of commodity price for Pizza Hut. But obviously, this year, the focus on cost savings and also targeted market promotions, we benefit from lapping of very heavy promotions in comparison to last year.

So in terms of cost of labor, we still have wage inflation, but it's much more moderated this year for both fronts. Because a lot of the minimum wage increase mandated by government have been delayed or postponed, so it's more benign. I think if you look at wage inflation, we'll probably at low single-digit this year. And so -- but we do expect some catch-up there.

The other one is that there have been some labor shortage that also accentuated the labor productivity gain, right. So people actually have to work for a bit extra harder. So we -- as we mentioned on the prepared remarks, we do think that in the coming months, we may have to increase the staffing levels to ensure that we have a balance of efficiencies as well as service level.

In terms of -- you mentioned O&O. I think there's a lot of improvement there. And I think, again, this is coming down to a number of things. It's not just 1 initiative. There's a lot of cost initiatives. We have seen lower utility costs. We also see lower maintaining cost and rent relief there as well.

So I think in terms of the margin perspective, I think the commodity inflation in certain area is moderating a little bit, compared to early part of this year, but we still -- we're looking to that, especially when we go into next year. In 2021, we basically will be stacking up 2 years of inflationary pressure. For example, wage increase, I mentioned before. Likely, there's going to be some catch-up in terms of those costs. Some of those initiatives are sustainable. So if you look at, for example, in cost of labor, we do see productivity gain from using technology, as we have mentioned a few times, the automated scheduling, the pocket store manager, real-time tracking. All of these will help us in the longer-term focus of the improvement.

But as I mentioned here, the labor shortage and the increased staffing levels in the coming months, it may reverse some of those gains. So -- and then the subdued wage inflation this year, may have some catch-up with you next year. But all in all, I think some of those labor productivity improvement will stay, some of them may need to ease up a little bit so that we don't go overboard.

In terms of commodity inflation, I think if you look at overall inflationary pressure, it's easing a little bit. Still, pork is still very elevated, the prices. It's probably 20%, 30% higher compared to last year. But for poultry, like chicken, that pressure have eased a bit as the supply come back in. So that may help us a little bit on the cost of goods sold. However, as Joey mentioned, value promotions, value for money is very important proposition for consumer in this new normal. And so we may get back some of those savings in terms of poultry prices back to consumer, to drive more traffic back to us.

So hopefully, address your questions?

Operator

And your next question comes from the line of Lillian Lou from Morgan Stanley.

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

And congratulations again. So I think my question on margin is well answered by Andy personally. So I think my next question is more on the development of China cuisine. So I know the fast expansion of units partially from Huang Ji Huang, but I want to check what's more longer-term thoughts behind the development of this newly set-up division.

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

Lillian, this is Andy. Let me try to address your question here on the Chinese cuisine business. Obviously, we think that the Chinese cuisine is a very big market. Chinese cuisine take the lion's share for consumer here in China in terms of dining outside. So there's a lot of opportunity for us.

In terms of Chinese cuisine business, with the consolidation of Huang Ji Huang and with our existing brand of Little Sheep and East Dawning, we formed the Chinese cuisine business this year, and the unit is led by Ted Lee. And he has been obviously responsible for the turnaround of Little Sheep over the last couple of years.

In terms of Chinese cuisine business, we have -- our goal is really try to leverage Yum China's scale, supply chain, our franchise, communication and our delivery partnership, for example, with a different aggregator, which offer a significant preferential rate for us.

In terms of -- we also want to take advantage of the food innovation capability. So if you look at Little Sheep, we launched a simmered pot product, similar products. And we are also looking into -- for Little Sheep, for example, growing other product category like barbecue, for example. And we also -- we can see a great opportunity in the seasoning and sauce business. And so we have seen Little Sheep sort of growing that business over the past couple of years.

Huang Ji Huang also have a very good sauce that they use at the store. And we see an opportunity for them to actually leverage that up to consumer business. So if you look at the Chinese cuisine business, this year, I think a lot of this work will be focusing on integration of Huang Ji Huang, making sure that we can drive that synergy, not just about cost, but also product innovations, about distribution channels, about franchisee space opportunity there.

So in terms of next year, I think we would like to see moving into more growth mode, seeing more growth in the franchise space as well as more progress on the seasoning and sauce business.

So this is about our current view looking at Chinese cuisine business.

Operator

And your next question comes from the line of Michelle Cheng from Goldman Sachs.

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

Congrats for the good result. And I just want to -- I wonder whether you can share some color about the recent trend. Since earlier, you mentioned that transportation hub is still around 20% plus below the normalized level. So trying to understand whether we are seeing a more significant improvement in like October, since we hear some relative positive data point from other retailers and restaurants.

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

Michelle, so the trends, I mentioned a bit earlier about KFC, the key pillars for the business recovery. The delivery is still growing. The regional difference continue, but the gap reduced. The recovery in weekend and weekdays, even now, and when it comes to the transportation hub and tourist location, the transportation hubs business for KFC, because Pizza Hut does not have much business in transportation hub, so it's mainly for KFC, it's still below the pre-outbreak period, and we mentioned about -- probably about minus 20%, even during the big holidays, and the international traffic is still very limited due to the ongoing concern of the COVID-19.

But one thing we would also like to caution our investors and analysts is post-holiday trading is still challenged. And that's a very, very interesting phenomenon because usually, when customers have concerns, still have the little concern of the overall economic situation, the job, et cetera, we tend to see pretty good trading during holidays.

But after the holidays, the little weakness actually, it shows the psychological impact. It's not only true in 1 country. It's been generally true across different culture, different countries. So we see a little bit of that, too. We would just like to caution our analysts about that.

But the overall trend is good. I mean, for China, we are grateful for that. The life in China is quite normal right now compared to U.S. and Europe. And the trading is vibrant. So we are very, very grateful for that. And let's hope that the good improvement, the ongoing recovery of our lives back to normal will continue. So that's where we are. Thank you, Michelle.

Operator

And your next question comes from the line of Christine Peng from UBS.

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

Thank you, Joey, Andy, for the very detailed explanation about the results as well as very positive outlook towards the future.

So I have a separate question, which is -- which might not be related to third quarter result. But Joey, I want to get your thoughts. So recently, we read from some news reports that your company is launching Kai Feng Cai, which is the packaged food brand throughout China, starting from the KFC retail units. So can you share with us your mid- to long-term thoughts towards this business initiative? And if you can share with us more color in terms of the branding, pricing, distribution strategies? They'll be very much appreciated.

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

Thank you, Christine. I mean, obviously, it will be hard to serve Re Gan Mian because you need to be in Wuhan. It will only serve Wuhan. But hopefully, we will be able to have the opportunity for yourself to try our Kai Feng Cai products.

For our experiment, in the retail business, partly it's natural. Why do I say that? I'll explain it later. Partly because of the innovation that we come up with during the COVID-19. So during the COVID-19 time, obviously, we have seen the trend, which is related to Michelle's question earlier. One trend is the increase of the home consumption Ren, Huo, Chang right, the people, product and occasions. So the home occasion is -- the consumption is increasing, and we can see that. And Pizza Hut respond during the COVID-19 very quickly by launching the steak, the prepared steak, but it is cooked at home, and the result is very good.

And KFC has its own take of the home occasion opportunity. And we leverage our product innovation team, which is a fantastic team. They come up with all sorts of very yummy and great product, and they come up with a lot of these product that could be consumed at home. And so far, we have launched the chicken soup Ji Tang. We have launched the Luo Si Fen and it is a kind of rice noodle from Guangxi area with very strong smell. And then we have launched others like the chicken breast, right?

So we launched a product innovation team. And right now, we are testing it and selling it in mainly top-tier cities because it takes time to build up the volume because this is a volume game as well. And the result is very encouraging. And we leverage our current existing channels, such as the e-commerce channel, such as our own APP, our own app, such as our own current stores to sell the product. And customers can buy the product through our stores as well. So they can buy the product in the store, and they can be delivered by our own in-house delivery team.

So you can see how we do it. We leverage our product innovation team, our distribution channel, our store team, our delivery infrastructure to expand the business. So that's where we are right now. And still early days, but we are quite excited about the progress. And the name of Kai Feng Cai, I probably mentioned it before, if I repeat, I'm sorry, it's a name that customers in China, Chef KFC. This is the local version, local name for KFC. But it's more in a funny way. We just take it as a complement, so we call ourselves Kai Feng Cai, and people got it immediately because that has been the name being used for many, many years, but never been used officially. So we make it official. So that's where we are.

And of course, you might notice that we have also launched the coffee capsule. We call it Xiao Hei Dan because it's in a little tiny small coffee cup, and is the upgraded version of instant coffee with different flavors, stuff like that. And again, we tried it in top-tier city, and we are happy with the testing and the progress.

So the retail business of KFC and Pizza Hut is an area that we are still learning. And we are looking forward to delivering more this kind of yummy products to our customers. Thank you, Christine.

Operator

And your last question comes from the line of Anne Ling from Jefferies.

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

Just 1 minor thing. Regarding management mentioned earlier that in third quarter, delivery business. One of the key driver has been like the corporate delivery. May I know like, is this corporate delivery like mainly for -- from KFC? Or it's also for Pizza Hut? And what is the growth potential over here? How much of the sales is -- or the delivery sales has actually come out from this corporate delivery? And I understand that we also start to like launch like delivery to park and all the initiatives. So I just want to see, are these like the new like growth driver for the delivery side?

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

Thank you, Anne. For the corporate delivery, we have been working on the system development because all these need to be supported by a very strong IT system. Since last year, and originally, we targeted to sell -- to expand our business to like 5,000 companies for this year. And then the COVID-19 hit. And we delivered a lot of free meals, about 170,000 free meals to over 1,450 hospitals and community centers in over 28 provinces. And suddenly, we became famous for the corporate delivery due to our effort in COVID-19 by trying to do the right thing. Because no matter how difficult the delivery, even for the food is free, we always emphasize on hot food. And that's our commitment. And so that gives us extra opportunity for company delivery because when the business recover, start to recover, back to March, April, KFC and Pizza Hut is -- are one of the few trusted brands that we still have the majority of our stores open, and people came to us, trusting our brand and food quality.

So we have this unique opportunity. And suddenly, the demand is much higher than we thought, and we respond very quickly. And the benefit of corporate delivery for KFC and Pizza Hut in Yum China is we don't have to hire a new set of sales team to do that, which is something quite essential if you're a new brand of business. We have all our stores. We have more than 10,000 stores right now in 1,400 cities. And our store manager and their managers, they are fantastic people and driver behind this. So as of right now, we have worked with more than 20,000 companies on that. And not only the breakfast but the over time, new and the Double 11 is coming, you can imagine will provide very strong support as well.

To do that, not only it require more customized menu, but also require system integration. The payment, because we want it to be very convenient for staff to order, KFC, Pizza Hut or other brand food in their own company website or with their own payment or partly subsidized by the company, et cetera, et cetera. It could be very complicated combination. But we make that all easy convenient for them. And thus, this business kind of is growing from strength to strength.

But with that said, KFC and Pizza Hut in Yum China, the base is so big. So when it comes to your question about what the percentage of sales, it's still quite small. And it's very, very hard to get a big % of sales given our base is so big. But it's very meaningful, particularly meaningful for the stores that have opportunity to support some companies. You can imagine, the sales increase is meaningful.

So that's where we are right now. We continue to expand our network of providing good food and good value for our customers. So you can imagine, we have the network of over 10,000 stores right now and between 1 store and another store, there are a lot of connections here we can do more by offering corporate deliveries or working with our business partner to deliver the service required for our customers.

So that's where we are right now. And when it comes to small things like opening stores in part or even having Zao Can Che, those small kiosks in some very convenient location, you can see it from the paradigm that we are trying to use our store as a network to further increase the connection point with our customer by improving the convenience to the customer. And you actually will start to see some. It's not a lot yet, but 1 example is in Qingdao, is the delivery box. There's a wall of delivery box and customer will pick it up at a certain point -- a certain spot of the office building, et cetera, et cetera. So these are all the things that we are exploring, but it's all from customers' point of view. Good value, good food and convenience. Thank you, Anne.

Operator

Thank you so much. There are no further questions at this time. Speakers, you may continue.

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

Thank you very much. Thank you.

Debbie Ding ***Yum China Holdings, Inc. - Senior IR Manager***

Thank you for joining the call today. We look forward to speaking with you on the next earnings call. This concludes today's call. Have a great day.

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

Thank you, everyone.

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

Thank you.

Operator

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

DISCLAIMER

Refinitiv reserves the right to make changes to documents, content, or other information on this web site without obligation to notify any person of such changes.

In the conference calls upon which Event Briefs are based, companies may make projections or other forward-looking statements regarding a variety of items. Such forward-looking statements are based upon current expectations and involve risks and uncertainties. Actual results may differ materially from those stated in any forward-looking statement based on a number of important factors and risks, which are more specifically identified in the companies' most recent SEC filings. Although the companies may indicate and believe that the assumptions underlying the forward-looking statements are reasonable, any of the assumptions could prove inaccurate or incorrect and, therefore, there can be no assurance that the results contemplated in the forward-looking statements will be realized.

THE INFORMATION CONTAINED IN EVENT BRIEFS REFLECTS REFINITIV'S SUBJECTIVE CONDENSED PARAPHRASE OF THE APPLICABLE COMPANY'S CONFERENCE CALL AND THERE MAY BE MATERIAL ERRORS, OMISSIONS, OR INACCURACIES IN THE REPORTING OF THE SUBSTANCE OF THE CONFERENCE CALLS. IN NO WAY DOES REFINITIV OR THE APPLICABLE COMPANY ASSUME ANY RESPONSIBILITY FOR ANY INVESTMENT OR OTHER DECISIONS MADE BASED UPON THE INFORMATION PROVIDED ON THIS WEB SITE OR IN ANY EVENT BRIEF. USERS ARE ADVISED TO REVIEW THE APPLICABLE COMPANY'S CONFERENCE CALL ITSELF AND THE APPLICABLE COMPANY'S SEC FILINGS BEFORE MAKING ANY INVESTMENT OR OTHER DECISIONS.