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Q2 2024 YUM CHINA HOLDINGS INC EARNINGS CALL

EVENT DATE/TIME: August 06, 2024 / 12:00AM UTC

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PRESENTATION

Operator

Thank you for standing by, and welcome to the Yum China second-quarter 2024 earnings conference call. (Operator Instructions) I would now like to hand the conference over to Ms. Florence Lip. Please go ahead.

Florence Lip *Yum China Holdings Inc - Senior Director - Investor Relations*

Thank you, operator. Hello, everyone, and thank you for joining Yum China's second-quarter 2024 earnings conference call on today's call, our CEO, Ms. Joey Wat, and our CFO, Mr. Andy Yeung.

I'd like to remind everyone that our earnings call and investor materials contain forward-looking statements, which are subject to future events and uncertainties.

Actual results may differ materially from these forward-looking statements. All forward-looking statements should be considered in conjunction with the cautionary statements in our earnings release and the risk factors included in our filings with the SEC.

This call also includes certain non-GAAP financial measures. We should carefully consider the comparable GAAP measures. Reconciliation of non-GAAP and GAAP measures are included in our earnings release. You can find a webcast of this call and a PowerPoint presentation on our IR website.

Please note that during today's call, our year-over-year growth results exclude the impact of foreign currency unless otherwise noted. Now, I would like to turn the call over to Joey Wat, CEO of Yum China. Joey?

Joey Wat *Yum China Holdings Inc - Chief Executive Officer, Director*

Hello, everyone, and thank you for joining us. Today, Yum China reported record levels of revenue, operating profit, and EPS for the second quarter. System sales grew 4% on top of 32% growth in the same period last year. Core operating profit grew 12% to USD 275 million. EPS increased 19%.

I would like to thank our colleagues for their hard work and innovative spirit. We are navigating a complex and dynamic environment. Yes, but we see the many challenges more as opportunities. With our industry-leading capabilities and our scale, we are turning these situations to our competitive advantage. We have taken aggressive steps to drive revenue and profitability.

I would like to highlight three of them. First, we took a fresh look at every key process and cost elements in our businesses. We make countless innovations to improve our operational efficiency, enhance profitability and increase resiliency. We are already seeing results. We are achieving major cost savings and reinvesting them into food and value.

Second, we broadened our addressable market and held market share with our sharp focus on value for money and innovative products. Our transactions and delivery sales both grew by double digits in the second quarter. We will continue to innovate across our menu to address customer needs.

Third, our breakthrough business models, KCOFFEE and Pizza Hut WOW, achieved encouraging initial results. These stores delivered incremental same-store sales and incremental profit. They are showing great future potential. These strategies are working well. Q2 was our most profitable second quarter since our spin-off. Restaurant margins stabilized. OP margin expanded to 9.9%.

Let me first talk about our initiatives to drive operational efficiency. These initiatives cover all aspects of our organization. First, Project Fresh Eye launched in quarter four last year, helped improve OP margins this quarter.

We are shooting for best-in-class and best-in-cost. We are assessing our operations from our RGMs, in other words, store managers, point of view, supporting our RGM better and faster. From our restaurants to back offices, we are reducing complexity and simplifying operations.

All our major initiatives are now in place. The result is fewer unnecessary process burdens on our RGMs and better efficiencies. Separately, we launched Project Red Eye at the end of quarter one to improve our supply chain efficiency. Our goal is to spend better and buy better.

To spend better, we are assessing our operations from our customers' point of view, identifying areas that add no value for them. We are also simplifying our ingredient SKUs, packaging and menu in a certain segment of stores and select dayparts without compromising sales.

To buy better, we are sourcing directly from farmers and producers for certain categories by systematically examining our operations from fresh perspectives, we are uncovering numerous opportunities. We are doing all of this while ensuring food safety and quality.

Lastly, AI and automation will continue to play a big role in our business. We have automated major restaurant management tasks from sales forecasting to labor scheduling and inventory management. We have rolled out iKitchen to all Pizza Hut stores. This integrated AI system enhances food quality and improves operational efficiency.

We were among the first in our industry in China to adopt generative AI in 2023 to turbocharge our back office processes. We are working on a few dozen generated AI applications, including consumer insights, customer support, food safety, and new product innovation.

These tools are already helping us improve efficiency, and make more informed data-driven decisions. We are making great progress with these measures. Some have already impacted our second quarter results, while others will take more time to bear fruit.

Importantly, these are structural improvements that will bring long-lasting benefits. With these measures in place, we have the bullet to compete on value, and pursue growth in this dynamic environment. With that, let me turn to our brand strategy, starting with KFC.

In our 37 years in China, KFC has introduced many popular product categories. Recent innovations include our juicy beef burgers and whole chicken. Customers appreciate these new products, but they also love the fresh energy we bring to our iconic classics.

In May, we combined our original recipe chicken and mashed potatoes to create a brand-new burger, the original recipe chicken burger, [Yuan Wei Ji Han Bao].

By the way, the classic way to enjoy KFC's Original Recipe Chicken is with mashed potatoes, at least for kids in China. In the past, they were ordered separately. Now we put them together into one burger. As one customer told me, it is a childhood dream come true. This innovative burger sold out in many locations in just two days and drove incremental sales and profit. Since it was so popular, we launched it again for a limited time in June.

KCOFFEE is available in all KFC stores. Its sales exceed CNY1 billion in first half of 2024, up 26% year-over-year. During this period, we sold nearly 120 million cups, up 36% year-over-year. We have been accelerating the rollout of our groundbreaking side-by-side KCOFFEE cafe since late last year. From just 100 stores in March, we tripled the number to nearly 300 in July.

Side-by-side KCOFFEE cafes feature a distinct dining area and menu, starting at CNY9.9 at our campus stores, customers can enjoy our innovative coffee and a hotdog. We also took our popular sparkling Americano to the next level with the introduction of the Iced Orange Creamy Sparkling Latte (Bing Cheng Cheng Ke Mu Su Qi Pao Na Tie), very long name. The mousse-like smoothness, fizzy burst and citrus flavor are mind-blowing.

Thanks to our superb supply chain and efficient operations, we are making healthy margins too. This is a winning model. By year-end, we expect to roll out our KCOFFEE Cafe to 500 to 600 stores.

Delivery sales continued their double-digit growth momentum at KFC. We lowered the delivery fee in quarter one to capture the underserved smaller ticket segment. These strategic moves proved successful as we gained market share on aggregator platform.

We drove incremental sales and profit without impacting margins. By introducing platform riders at select locations, we optimized rider cost while maintaining service quality and customer satisfaction.

Now turning to Pizza Hut. This quarter, Pizza Hut achieved its most profitable second quarter since the spin-off. On the sales side, we were up against an outsized comp in April from a successful IP marketing campaign last year. In May and June, same-store sales improved.

Despite sales deleveraging, we improved our profitability by enhancing operational efficiency. For example, we significantly reduced product preparation time by simplifying menu and kitchen operations. We also deployed automated fried rice machines and robotic servers to make our crews work low lighter. It had just hit the 3,500-store mark. We believe Pizza Hut has huge potential.

Now present in over 750 cities, there are 1,300 cities that have a KFC but no Pizza Hut as yet. In addition to expanding its footprint, Pizza Hut is also reaching new consumer groups with amazing value, innovative products and business models. Here are some highlights.

First, menu innovation. Our entry price pizzas are addressing previously underserved segments and grew double digits this year. Our new pizza burger [PI Sa Bao], is attracting many solo diners. This unique burger made with a freshly-baked pizza dough bun, is receiving rave customer feedback.

In quarter two, we sold more burgers than Hawaiian Pizza, one of our signatures. Encouraged by its success, we will be rolling the Pizza Dough Burger out to all 3,500 stores later on this month. Second, our Pizza Hut WOW store models marks a major breakthrough.

We successfully attract solo diners, young people and more value-conscious customers. The model features simpler operations, good food variety, and excellent value for money. It is the fast casual format with lighter service.

Since opening the pilot store just in May, we have converted over 100 existing stores to this model by end of July. Initial results of the WOW model are encouraging. I visited some of our newly opened stores last month. Sales were vibrant with customers queuing outside.

Our first batch of new stores achieved significant same-store sales uplift. Given the encouraging results, we are accelerating the store rollout. By year-end, we expect to more than double our WOW store count.

Now let me talk about our store expansion. We are seeing fantastic long-term growth opportunities in China. Our flexible new store formats allow us to penetrate profitably across city tiers and locations. Our new stores maintained good returns. Their payback period held steady at two years for KFC and improved to two to three years at Pizza Hut. Around 80% of our new stores achieved monthly breakeven within three months.

We focus on white space to minimize the impact on existing stores. KFC's small town mini model is unlocking new site possibilities in lower-tier cities. We have also identified opportunities in strategic locations like college campuses, gas stations, highway service centers and other transportation hub and tourist locations.

KFC's new store at Shanghai Xiaotong University [Jiao Da], for example, is enjoying busy on-campus traffic. We are also leveraging partnerships with franchisees to unlock opportunities in lower-tier cities and strategic locations. In the second quarter, net new stores from franchising reached 25%. We expect the ratio will go up slightly exceeding the 15% to 20% target we set at our Investor Day last year.

Now let me recap the three key messages I want you to take away today. First, we took actions to drive operational efficiency, which enable us to invest in value for money and to support our margin.

These efforts were not just one-off cost cuts. They were structural improvements that should deliver benefits for years to come. Second, we embrace consumer needs and succeed in driving robust transaction growth. We are confident that our sales initiatives will drive sustainable long-term system sales and same-store sales growth.

Third, innovation in new store models will continue to power our long-term growth. Our Q2 results show that our strategies are working. Great companies thrive in tough conditions, and turn challenges into opportunities. I'm confident in our ability to navigate the current environment, and emerge stronger than ever.

Before we move on to our financial results, I would like to take a moment to recognize the tremendous contribution that Andy has made to Yum China. Andy has played a critical role in enhancing the company's financial strength, establishing robust cost discipline and supporting our growth strategy.

Under his leadership, the finance team further strengthened its core capabilities and upgrade its systems and processes in key areas. He also successfully led the completion of our listing in Hong Kong. I would also like to thank Andy for his commitment to transitioning Adrian Ding into the acting CFO role. Please join me in wishing Andy the very best.

I am very pleased that Adrian will step up as Acting CFO. Adrian is our current Chief Investment Officer and General Manager of Lavazza. Over the past five years, Adrian has led multiple investments and capital market projects to enhance our portfolio and organizational strength.

He was instrumental in establishing the Lavazza joint venture and building the Lavazza business in China. With his financial and operational expertise, I'm confident that Adrian will support our growth objectives to create sustainable value for our shareholders.

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

Andy Yeung *Yum China Holdings Inc - Chief Financial Officer*

Thank you, Joey, and hello, everyone. As this will be my last earnings call with Yum China, I want to express my sincere gratitude to Joey, my colleagues and shareholders and our analysts. Over the past five years, it has been a rewarding experience working closely with such a talented and dedicated leadership team. I'm proud of the accomplishments that we have achieved together, navigating the challenges posed by the pandemic and its aftermath. Yum China emerged from the pandemic, more resilient and ready to accelerate growth.

I'm confident in the company's continued success under the capable leadership of the existing management team. Now let's turn to our financial results. In the second quarter, we delivered a solid performance and set numerous new records, including revenue of $2.68 billion, operating profit of $266 million, operating margins of 9.9%, and diluted EPS of $0.55. That's for sure impressive given the current market condition.

As Joey shared earlier, the initiative that we launched beginning in the fourth quarter of last year to drive sustainable growth and protect margins are beginning to pay off. While tough lapping and current market conditions impacted same-store sales, our margins stabilized.

Our sales growth was led by healthy traffic. Total transactions grew 13%, and same-store transactions grew 4% year-over-year in the second quarter. It's a testimony to how well our brand, product, marketing and promotions resonate well with consumers. We attract new customers and capture more occasions from existing customers by broadening our price range, and offering delicious food at affordable price points.

Despite a lower ticket average, restaurant margin was relatively flattish year-over-year on a comparable basis. Core operating margin actually improved year-over-year, setting a new quality record for operating margin, thanks to our economy of scale, and cost measures.

Taking a longer view, our system sales grew 25% compared with the second quarter 2019, outperforming the restaurant industry. Operating profit increased even more by 38% compared to 2019, excluding foreign exchange.

Now let's take a closer look at our second quarter performance. By brand, KFC system sales increased 5% year-over-year. Same-store sales were at 97% of prior year levels, with 4% same-store traffic growth and 7% lower ticket average. Looking at it from a longer term perspective, our ticket average in the second quarter was RMB 37, higher than the RMB 35 ticket average in the second quarter of 2019. Our strategies to widen the price range and capture lower ticket average delivery orders are paying off. Our entry price combos drove incremental traffic. Delivery sales grew 12%. Pizza Hut system sales increased 1% year-over-year. Same-store sales were at 92% of the prior year level with traffic growth of 2% and a 9% lower ticket average. Pizza Hut continued to tap into more value-conscious consumers and solo diner segment, with entry price pizzas, burgers and one-person meals. The ticket average went down in keeping with our strategy, but profitability improved year-over-year through our team's relentless efforts to drive efficiency. Now let's go through our margin in key cost lines.

Our operating margin as a percentage of revenue was 9.9%, the highest second quarter record since our spinoff. Resilient restaurant margins and proactive savings in G&A expenses helped us achieve that. Our restaurant margin was 15.5%, 60 basis points lower than last year or approximately the same on a comparable basis.

Savings in cost of labor and occupancy and other costs offset increases in cost of sales. Cost of sales was 31.5%, 80 basis points higher year-over-year or 70 basis points higher on a comparable basis. COS was at a healthy level and consistent with our long-term range of 31%, plus or minus 1%. We managed our COS tightly despite offering more value for money. Our food innovation capabilities and superb supply chain allowed us to invest in sales-driving initiatives and promotions.

Cost of labor was 26.3%, 10 basis points lower year-over-year. Improved operational efficiency more than offset last year's wage increases for our frontline staff and the sales deleveraging impact. Occupancy and other was 26.7%, 10 basis points lower year-over-year or 50 basis points lower on a comparable basis. This comes from lower marketing and advertising expenses and other cost optimization.

Our G&A expenses decreased 11% year-over-year. We drove operational efficiency gains. We also save on lower performance-based compensation this year. G&A expenses as a percentage of revenue was 5% in the quarter, improving from 5.8% a year ago. For the full year, we aim to keep the G&A ratio around 5%.

Our effective tax rate was 25.2% in the second quarter, on par with the same period last year. We expect our full year effective tax rate to be in the high 20s. Operating profit was $266 million, a second quarter record, growing 7% year-on-year. Core operating profit was $275 million, growing 12% year-over-year. Diluted EPS was $0.55, also a second quarter record, growing 19% year-over-year.

Finally, moving on to our outlook. The market conditions remain challenging. We will continue to invest in value for money and step up product and marketing innovations to drive transaction growth. Our operational efficiency buy better and spend better projects are not temporary measures.

We expect cost savings from Project Fresh Eye and Project Red Eye to continue in the second half. These transformative changes should position us well to remain best in class and best in cost in our business, making our value proposition sustainable and profitable in the long run.

Our disruptive new business model like KFC, side-by-side KCOFFEE Cafe and Pizza Hut WOW stores are promising to further same-store sales growth potential. As a reminder, we recorded around $15 million in temporary relief and VAT deductions in the third quarter of last year. We do not expect this to recur this year. We expect wage inflation for our frontline staff to remain at low single digits.

We opened a record 779 net new stores in the first half and reached 15,423 total number of stores. We are on track to achieve our full-year target of 1,500 to 1,700 net new stores. We are also on track to return $1.5 billion to shareholders.

In the first half, we returned nearly $1 billion, including buying back 21.7 million shares. This is equivalent to over 5% of our outstanding share. Our strong cash flow generation and healthy cash position continue to power our capital return to shareholders.

At the end of the second quarter, we had $3.1 billion in net cash. Our three-year growth target remain unchanged. We are committed to returning at least $3 billion to shareholders while driving long-term and sustainable growth.

Now with that, I will pass it back to Florence. Florence?

Florence Lip *Yum China Holdings Inc - Senior Director - Investor Relations*

Thanks, Andy. Now we will open the call for questions. In order to give more people the chance to ask questions, please limit your questions to one at a time. Operator, please start the Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Michelle Cheng, Goldman Sachs.

Michelle Cheng *Goldman Sachs Group Inc - Analyst*

Joey and Andy, congrats for the still very strong and resilient numbers and also, Andy, all the best. So, my question is about this new business format and store concept. And it's really impressive that we have a very aggressive opening year-to-date. And thank you, Joey, also sharing the target by end of the year but can you please give us more color about the economics and also the contributions at KCOFFEE side-by-side stores in same sales for those stores, we already have these openings in the past few months. And given it's still more value position.

So when we think about the economics, should we see that these food cost ratio will be higher, but this will be offset by like more simplified cost structure in O&O, payroll and net net from the margin perspective, structurally, we will see more upside from this new model? And also, are we going to see more new concepts in addition to the KCOFFEE and WOW in the next few quarters? Thank you.

Joey Wat *Yum China Holdings Inc - Chief Executive Officer, Director*

Thank you, Michelle. It's truly amazing for our team to have this breakthrough and we are very excited about it. And I will answer your last question first is we are going to focus on these two-breakthrough models out of KFC and Pizza Hut.

And I think the initial results are very encouraging, and we'll focus on that for the rest of the year and going forward. Come back to the content of the new concept, first of all, the easiest way is travel to Shenzhen. I encourage all our analysts just cross the border, I recently visited the one in Yifan Cheng Uni Center, I think, it's a Pizza WOW. And then we have a few other KCOFFEE side by side. And you can see the menu, the operation, and you have a very good feel about it.

So for KCOFFEE, it has its own menu. The menu is very simple. And then in terms of the product, we have some winning product, the Sparkling Coffee is a fantastic product and food is also important. And that comes to the next characteristic of KCOFFEE is we share the kitchen and the operation with the normal KFC store.

So the kitchen is shared. Operation team is shared, but it has its own distinct area. And then for the customer, the value for money is amazing, and I will highlight one particular offer, which I mentioned in my remarks, is the -- in the campus.

Campus KCOFFEE store, we actually offer sparkling coffee with a hotdog at 9.9 yuan. You might naturally ask the question how does it work for the margin. Well, think about this way, for many years already, we offer our breakfast at 9 yuan, 8 yuan. We offer the food and the coffee comes for free. In KCOFFEE, it is the reverse.

We sell the coffee at 9.9 year and food is free. So it's in our supply chain capability that we can do this in a very competitive way. So net net, the margin is healthy. And then in terms of result, the adds both incremental same-store sales and incremental profit. Now come to the WOW Pizza Hut store.

So it's sort of a bit more fast casual with a bit less service, just a little bit, how do I describe this? The food offering is a bit like Pizza Hut, but tapas, [dianxin] smaller portions, lower price. But if you go in there by yourself, you can order a bit more for variety, but total ticket average is less than the normal Pizza Hut store. But the traffic is fantastic.

So overall, it works and the same-store sales increase is very encouraging. And for the Pizza Hut WOW store, we just convert some of our Pizza Hut stores into this new concept. It's conversion basically. So right now, we have 100 stores converted by the end of July, and we plan to over, -- achieve over 200 by the end of the year. And in terms of COS, margin, it's actually better. Although it's early days, but the unit economics is better because COL and O&O is a bit less.

So that's what we can share with you right now. But the #1 suggestions is cross the boarder and go and see some in Shenzhen. Thank you, Michelle.

Michelle Cheng *Goldman Sachs Group Inc - Analyst*

Thank you, Joey. I very looking forward to.

Operator

Lillian Lou, Morgan Stanley.

Lillian Lou *Morgan Stanley - Analyst*

Hello, Joey and Andy. My question is about the recent trend on the same-store sales and also, again, congratulations on giving such a good result and even under a bit challenging environment. So I want to understand getting into the quarter, fourth quarter when the top comp kind of alleviated a bit.

And with all this cost efficiency put in place, how we should look at the operation on a holistic basis? And have you seen different trends in different tiers of markets, in terms of the demand and the cost management like high-tier city and low-tier cities? Thank you.

Joey Wat *Yum China Holdings Inc - Chief Executive Officer, Director*

Thank you, Lillian. Let me share a little bit learning from the quarter one trading pattern and then make a few comments about the quarter two. By region, the Eastern part of China is still the most resilient one. By city tier lower tier city recover faster than higher-tier city, both year-on-year and versus longer term like pre-pandemic 2019. By location, the residential locations are more resilient and shopping centers are almost back to 2019 levels. And moving on to the business environment, there's been a lot of attention to the business environment and consumer sentiment in China.

We are not seeing significant change in market conditions and consumer sentiment going to quarter three, sorry. With that said, my management team and I share one particular philosophy on that. Yes, business is tough right now, but much like life, right? It's always tough.

In business as in life, we always expect the unexpected. We don't whine about it. We accept whatever comes our way and we adapt and do the right thing. Often in doing so, we are able to turn the disruptions to our competitor advantage by deploying our scale and our capabilities.

In terms of how to do it, et cetera, I have covered them in my remarks regarding the specific actions. But the three key points bear repeating in summary. First of all, to answer your question about the cost efficiency, we have tuned every process and cost element to drive operational efficiency, make our store managers work load lighter and reinvest into our value for money offerings and support our margins.

Second, we have innovated creative new products, which have lovely picture in the PowerPoint deck, and we widened our price points to broaden our addressable market and drive traffic. Third, we innovate breakthrough store model, such as the KCOFFEE cafe and mini store for small town for KFC and the fast casual model called Pizza WOW, which I just described, to power future growth of KFC and Pizza Hut.

Like all three strategies are showing strong initial results. As a result, for quarter two this year, we see robust growth or actually double-digit growth in transaction and delivery sales. Our restaurant margins stabilized and core OP grew by 12%. We see the most profitable quarter two since spinoff despite the industry dynamic. Thank you, Lillian.

Lillian Lou *Morgan Stanley - Analyst*

Thanks a lot, Joey. And best wishes to Andy.

Andy Yeung *Yum China Holdings Inc - Chief Financial Officer*

Thanks.

Operator

Chen Luo, Bank of America.

Chen Luo *Bank of America Corp - Analyst*

Hi, Joey, Andy, this is Chen. And congrats again on the strong result and also my best wishes to Andy. I'd like to take a deeper look at the margins, definitely our Q2 margins beat expectation. And when you're looking into the details, I noticed, first of all, the food and paper cost as percent of sales edged down by 60 bps on a Q on Q basis despite the fact that our promotion seems to be very intense in Q2.

So what is driving that? Is this because of the falling commodity cost? Or it's because of our smart value or the supply chain initiatives? And secondly, if you look at the cost of labor, it has declined big time on a year-on-year basis for Pizza Hut, and also the group is largely flattish versus the usual upward trend.

So what is also driving all these changes? And lastly, I noticed that our first half restaurant margin is actually pretty much on par with first half of 2019, which is usually regarded by the market as a normalized comparison base. Is it fair to say that going forward, our margins can be largely comparable to 2019 for the rest of the year? Thank you.

Andy Yeung *Yum China Holdings Inc - Chief Financial Officer*

Thank you, Chen for your question. And in terms of short term, I think, obviously, we are narrating some pretty dynamic, pretty complex operating environment in the short term. And consumer remain very value conscious.

And so that's an important thing to keep in mind. So from our perspective, if you look at third quarter last year, was not a particularly low base. If you think about last year, we see the consumer data softened in late September. So that's something that we keep in mind.

So in the short term, obviously, sales would be an important driver for margins as we have mentioned on the call. But nevertheless, as we have mentioned in our prepared remarks, we have taken very decisive actions to adjust our cost structure. And so that -- and then also, we have a very decisive action to change some of our business model to embrace the market change.

And so as a result, we're able to see stabilized UC margins. And then also, we see expansions in our operating margin to change that is the best since our spin off. Now if you look at our initiative, those initiatives are not a short-term measure. They are long-term structural change in the way how, not only the cost structure, but also how we operate our business, make it more efficient. In the short term, I think like if you think about the commodity price in the short term, some of the commodity prices more favorable.

But at the same time, we, again, have mentioned over and over again, that it's important for us to invest in value, invest and embrace the consumer changes. And so still the COS sometimes it fluctuates, as we have mentioned before.

We always -- in the long term target 31% plus or minus 1%, and sometimes seasonality fluctuations. I think all in all, we are on the mark for that. This quarter is about 31.5%. So in terms of COL, yes, you did see quite a bit of improvement in labor productivity. And that will continue to be some of our focus. We will continue to looking to our operations, simplify some of the procedures and make sure that what we do actually add value if what we do don't add value, they're not viable for the RGM or consumer, will take it out.

But when we look at, in the second half of this year, for example, the full year this year, we do expect COL inflation at the soften level to be at low single digit. And then in terms of O&O, I think it continues to be an area that we have initiatives to try to improve that.

But obviously, these are composed of many, many things, right? Capital allocation for store investments that impact depreciation and then also rent is the big things we continue to work on, marketing leverage from our digital program.

And so we will have many initiatives to try to improve incrementally. And so -- but one thing I want to remind you folks, as we have reminded folks in the first quarter earnings call, which is last year, our company did enjoy some one time right, like rent relief and also VAT reduction, which was a big government policy that we didn't experience in the first half of this year, and we don't expect in the second half this year.

So that items that impact comparability for the second quarter last year was about $12 million, and then in the third quarter, it's about $15 million.

And so I think that's one factor that when you guys look at the model should keep in mind. And so in terms of G&A, I think as we have mentioned before, we will aim to keep G&A this year around 5% of our total sales- revenues. And that is a significant improvement compared to last year, and this is an improvement when compared to 2019.

And so again, like in the short term, this is how we look at it. But in the longer term, I think we aim for more stable -- relatively stable margins and look for way to improve our operating margins in the long run if possible. And then we, I think we have demonstrated, and I think we're confident that we can manage both growth and probability in good times and bad times.

And do we face challenges in the short term? Sure. But we have demonstrated, I think, and you can see the actions that we are taking to embrace the market changes, to adjust our cost structure, improve our operational efficiencies and also our change our business model. So I think that ability to make decisive changes, to embrace change, should help us to sustain margin in the long term.

Joey Wat *Yum China Holdings Inc - Chief Executive Officer, Director*

I'll just give two concrete examples for you, Luo Chen. For example, COS, right, in select categories right now, we go straight to the farmer and producer. We get really good ingredient at better price, you can totally imagine. We'll continue to do that.

In the COL, what are the specific things that you can see in our kitchen? 80% of our Pizza Hut store right now have automatic fried rice machine. It's pretty cool. You might consider to have one in your house. It's actually very small. So it really solve the labor shortage or labor problem, particularly during the peak time.

And then 50% of our Pizza Hut store right now have robotic server. Not all the store can do it, because store too small cannot benefit from it. (spoken in foreign language)

So this definitely a structural change to the COL. And then we have, as I mentioned in my prepared remarks, we have fewer SKUs at select dayparts. What does that mean? It means that we take out some tail for selected dayparts. Not throughout whole day, but just throughout certain time of the day, so that it has less wastage, spend better, right? Less wastage, therefore, less COS, less COL, that all makes sense. And these are the specific examples. Thank you Luo Chen.

Chen Luo *Bank of America Corp - Analyst*

Thanks a lot, Joe. Look forward to that automatic fried rice machine if it is available on shelf. And also that's my best wishes to Andy again.

Andy Yeung *Yum China Holdings Inc - Chief Financial Officer*

Thank you.

Operator

Anne Ling, Jefferies.

Anne Ling *Jefferies Group LLC - Analyst*

Hi, and thank you very much for taking my question. So I have a small one. The new format again. So moving forward, for example, for Pizza Hut WOW, does it mean that in the future on the store opening that because currently, you're mainly doing a conversion on the store. So moving forward for your new opening, will that also mean that some of the new opening will also be straight on Pizza Hut WOW. And based on your current network.

How many of them do you think that currently you can make this kind of shift and how quickly you can do that? Or like at what point you make a decision in terms of accelerating this rollout? And then for the KCOFFEE store, the same question is that under your current store network, how many stores are actually feasible for this kind of like adjacent store format? Thank you.

Joey Wat *Yum China Holdings Inc - Chief Executive Officer, Director*

Thank you, Anne. For Pizza Hut WOW model, it's one of the models. For both KFC and Pizza Hut, we actually have multiple store model for multiple locations and formats and city, et cetera, et cetera. Currently, for Pizza Hut WOW, we are testing this model in different part of the country, and also top tier city, low-tier city you can imagine.

So we will be a bit more clear later on in the year about how many of the existing stores that have the potential to be converted. And you can imagine some of the new store is suitable for this model. We will open Pizza Hut WOW as a new store as well.

Similar story for KCOFFEE, but not so similar. KCOFFEE is not so much a conversion. KCOFFEE Cafe is a bit like identify existing store, and we kind of have a side-by-side add-on sort of a distinct store to the existing KFC store.

But again, we are testing it in different parts of China right now and the most remote part is in Xigaze Tibet. And in tourist location. And then (spoken in foreign language), the [Hangzhou] high-speed railway station you can imagine.

So different locations, different city tier, we are testing it. And then we are building our food and also the drink of the KCOFFEE as well. So we have a bit more aggressive number of KCOFFEE, which is by the end of the year, 500 to 600 stores, but this is what we have in our mind, and we'll continue to learn and then we adjust and adapt and we accelerate the speed if we need to and we'll continue to learn.

Thank you, Anne.

Andy Yeung *Yum China Holdings Inc - Chief Financial Officer*

Thanks.

Operator

Brian Bittner, Oppenheimer & Co.

Brian Bittner *Oppenheimer & Co Inc - Analyst*

Thank you. Andy, it's been a pleasure working with you. Thanks for all the help over the years, and I wish you the best. I was hoping you guys could put some guardrails on how to think about the second half of the year for same-store sales. Of course, if we look at last year, the comparison gets a lot easier in the third and fourth quarter.

But given the operating environment, I'm not sure how relevant comparisons are. So is there, in fact, an opportunity for same-store sales to show some improvement in the second half, versus first half? Or is the message from you, that we analysts should remain pretty conservative and maybe expect more of a similar second half as what we saw in the first half?

Andy Yeung *Yum China Holdings Inc - Chief Financial Officer*

Hi Brian, thank you so much for your kind words and then also thank you for your question. I think in macro, I think there's a lot of news on the macro side. I think some of the complexities and potentially challenges in the Chinese consumer space or economy are well discussed.

What we try to mention on this call is that as a company, we continue to be able to take decisive actions to one to drive sales and the other one is to control costs. Those two are actually hand in hand, right? So something -- some of this initiative -- we would be able to take more control and it will result quickly.

And so as a result, you can see, our cost structure has improved quite significantly. And I think the strategy is working. On the other hand, we also pass along the savings to consumers, especially in the market where consumers are more value conscious. And so we'll continue to do that and channel some of the savings to invest in value campaign, some promotional activities to drive traffic.

And I think we also have some results that were pretty encouraging. If you look at our traffic growth, we achieved same-store traffic growth of low single digit this quarter. And then if you look at our overall traffic growth for our franchise overall, the brand, we're seeing double-digit growth in our store traffic.

And that is very important for our restaurant industry because traffic growth is what sustained long-term growth and profitability for our business. And so in terms of the macro outlook, I think, as Joey mentioned earlier, we don't see significant change going into the third quarter.

And we might focus that last year, third quarter was not particularly easy as you put it, because we're only beginning to see some softening in the consumer space in late September last year. And so you can -- if you go back to last year, the trend and what we have come in at that time. And so -- but good news is we have a lot of initiative and we drive that.

We have some breakthrough in our business model with Pizza Hut WOW model; with KFC, KCOFFEE Cafe model. And obviously, we also have a lot of initiatives on food innovation as a restaurant industry leading player. We're very proud of our innovative capabilities.

And that is very important to drive consumers to the store. And so we'll continue to do that, but as we caution people be overly optimistic in the second half. We're not pessimistic, but we shouldn't be overly optimistic.

Joey Wat *Yum China Holdings Inc - Chief Executive Officer, Director*

Thank you, Brian. Maybe I'll just add a few comments here. I mean, obviously, nobody has the crystal ball here. And I just want to emphasize that Yum China is a growing company in a growing market called China.

It seems quite fashionable these days to be bearish on China. But I just want to add that even at current growth rate, China still accounts for almost one-third of the world's annual growth. And particularly, the shift of growth to lower tier city kind of reminds me of the push into the frontier in the US, and part of yesterday's Wild West become today's Silicon Valley. And something like that has already happened in Shenzhen. So I'm confident that it will happen elsewhere in China as well.

Therefore, system sales is equally important compared to systems same-store sales. And we will try to focus on both system sales and same-store sales to have the balanced approach. And you will appreciate that we are also opening a lot of new stores, and that will have certain sales transfer in terms of same-store sales.

However, even with that, we are taking a balanced approach as well because 30% of our new stores actually are more on the strategic location or a small tier city where the sales transfer can be managed better, and more than half of our new stores in lower-tier cities these days. And last but not least, the KCOFFEE, Pizza Hut WOW actually are very focused on growing the same-store sales. So we try to focus and have a balanced approach.

Last but not least, it's not reported in media. But last year alone, China actually opened 400 shopping malls in mostly in Tier 2 and below. Think about how many countries in the world these days open 400 shopping malls. And for this year alone, 2024, we are expecting another 300 shopping malls to be opened in China.

So when new shopping mall opened like that, we shall open new stores. Even though it might imply sales transfer from the traditional high street to the new shopping mall because that's how economy evolves and low-tier cities develop. So just try to put some context into the background macro here. Thank you, Brian.

Brian Bittner *Oppenheimer & Co Inc - Analyst*

And I do appreciate the system sales side of the equation, but that the unit growth is what's known and the same-store sales is kind of what's unknown. And that was the essence of my question. Thank you.

Joey Wat *Yum China Holdings Inc - Chief Executive Officer, Director*

That’s true. Thank you, Brian.

Operator

Sijie Lin, CICC.

Sijie Lin *China International Capital Corp Ltd - Analyst*

Thank you Joey and Andy. Congrats for the high operational efficiency and strong bottom line, and best wishes to Andy. So I want to better understand our pricing strategy in the coming quarters especially KFC because for Pizza Hut, we want to introduce entry-level pizza and lower the ticket average.

But for Pizza Hut [should be referring to KFC] (added by company after the call), the TA is relatively stable over a longer period, although we are expanding price range. So recently, we observed that some other restaurant companies may hope to keep relatively stable TA this year after TA cuts last year. So how about our pricing strategy, especially for KFC, will we keep it relatively stable, or we may further increase promotion because elasticity of demand is still high and we have to pass savings to the consumer? Thank you.

Joey Wat *Yum China Holdings Inc - Chief Executive Officer, Director*

Thank you, Sijie. So the question is about the TA basically. And I presume the TA hidden question is about the margin. So the TA trend for both KFC and Pizza Hut is consistent with our strategy to drive traffic. Driving traffic is the most important thing in our business, and we see robust same-store transaction growth at both KFC and Pizza Hut.

And we see 13% total transaction growth for the business. And that represents the health of our business, by the way. Point 2 is even with the lower TA Q2 stabilized restaurant margins and improved operating margin because we take proactive steps to improve the operational efficiency as well.

So for KFC in the long term, we will take a balanced approach to maintain a steady TA. TA fluctuate quarter-by-quarter, and particularly compared to pandemic. However, if we take a long-term view, quarter two TA actually is CNY37 and it's still higher than the quarter two TA of 2019. That's pre-pandemic, and that's CNY35.

So in the long term, KFC, we have a very balanced approach. But in the short term, we will have sharp focused value, widen the price range because that worked well and that drove traffic as we can see. However, with that said, we also will continue to offer higher ticket items with strong value for money such as whole chicken, family bucket because they continue to do well, and they balance out the TA as well.

For Pizza Hut, TA come down by design since 2017. Every year, we want to take the TA down a bit. For quarter two, it's probably a bit more than we expected but it's okay. And let me add that Pizza Hut actually, April, the same-store sales suffer because of outsized promotion campaign last year, April. And by May and June, actually, it recovered the particular same-store sales, recovered pretty close to KFC.

So Pizza Hut will continue to tap into more value-cautious consumer and solo diner segments with entry price pizzas, burgers and one person meal, et cetera. And then, of course, the Pizza Hut WOW. By the way, the entry price pizza, which is below CNY50, which we talked about it in the last earnings release. This particular price point pizza is growing at double digit for us. It's very nice because it's expanding our market share in this particular segment. Thank you, Sijie.

Sijie Lin *China International Capital Corp Ltd - Analyst*

Thank you, Joey. That's very clear.

Operator

Xiaopo Wei, Citigroup.

Xiaopo Wei *Citigroup Inc - Analyst*

Hi, can you hear me? Thank you for taking my questions. Yes, Xiaopo Wei with Citigroup. A lot of things have been discussed in the prepared remarks and the prior Q&A I just want to understand that given this environment, a lot of things have been done by Joey and the team on the efficiency improvement. Have you thought about any disposal of a small business in this environment?

Because the small business in the past was intended for expansion of the business, but given all the environment and focus on efficiency, the small business may be a distraction of the resources. I just want to seek Joey's thinking on this perspective. Thank you.

Joey Wat *Yum China Holdings Inc - Chief Executive Officer, Director*

Thank you, Xiaopo. I mean your thinking is completely along the line of our thinking. We constantly review our portfolio of the smaller business. And then if I would like to make a few comments here is, for example, the new retail, I mean some packaged food, that smaller business served us well during the pandemic, where we could not open any stores in certain markets.

However, now business are sort of more back to normal and we can see the historical mission of the packaged food is probably accomplished. So we are going to probably reduce our involvement in it bit by bit very soon. So that's one example.

And then for other smaller business, we always have a very disciplined approach, which Andy has shared in previous interactions with our shareholders and analysts. We only invest a very small percentage of our profit on the small business. While it gives us the opportunity, the smaller business give us opportunity to learn, to train our staff and to fail. It's not set up to fail but smaller business is very challenging.

So we'll continue to review our portfolio. Lavazza actually is making really good progress. We have significantly more breakeven stores this year than last year, we are happy about it. The retail bean business of Lavazza is actually turning profitable in quarter two of 2024, and we expect meaningful sales growth this year.

And for Lavazza, we actually are moving coffee bean production from Italy to China so that we have fresher bean, more nimble innovation, lower costs, et cetera. So Lavazza will continue, and it's -- it takes time to build a good business, but it's really building step by step.

And then Huang Ji Huang and Little Sheep. Huang Ji Huang is a very resilient business. [Huang Ji Huang and Little Sheep] (added by company after the call) added 15 new stores in the first half, bringing our total to over 800 stores globally. And Little Sheep, we have this new model is to convert part of the store, sometimes the new store to serve one person and has achieved initial success, and we are building more stores this year.

And then Taco Bell is having a bit of a harder time because it is indeed a bit more foreign concept to Chinese consumer. So we need a bit more time, and we are starting out the portfolio to further improve the business model. And that's where we are but, Xiaopo, we are constantly reviewing the health of the smaller business. Thank you so much.

Andy Yeung *Yum China Holdings Inc - Chief Financial Officer*

Yes. So, Xiaopo, I will add a little bit more there. As any capital deployment in our company, we're very disciplined about it, be it store, be it model and the brand.

I think we have demonstrated in the past, and we'll continue to do that, which is when we see something that have potential, we'll continue to invest in that. And we don't have a requirement to say you immediately need to be profitable for a smaller brand.

For example, building a coffee brand in China will take time, right? But we see great progress, and we'll continue to invest in that. We also so we have closed some brands like C&J, right, like when we need to consolidate our resources focusing on the core business on Lavazza and now KCOFFEE at the lower end functional end of the coffee business. And so yes, so like capital deployment, including for the brand, for the store, the overall portfolio, will continue to remain very disciplined about it to make sure that capital deployed efficiently for our shareholders. Thank you, Xiaopo.

Xiaopo Wei *Citigroup Inc - Analyst*

Thanks, Andy. All the best. Thank you so much.

Joey Wat *Yum China Holdings Inc - Chief Executive Officer, Director*

Thank you all. Thank you.

Florence Lip *Yum China Holdings Inc - Senior Director - Investor Relations*

Thank you for joining the call today. For further questions, please reach out through the contact information in our earnings release and on our website. Thanks.

Andy Yeung *Yum China Holdings Inc - Chief Financial Officer*

Thank you.

Joey Wat *Yum China Holdings Inc - Chief Executive Officer, Director*

Thank you so much, guys.

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