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YUMC.N - Q3 2023 Yum China Holdings Inc Earnings Call

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PRESENTATION

Operator

Thank you for standing by. And welcome to the Yum China Third Quarter 2023 Earnings Conference Call.

I would now like to hand the conference over to Michelle Shen. Please go ahead.

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

Thank you, Zach. Hello, everyone. Thank you for joining Yum China's third quarter 2023 earnings conference call. On today's call are 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. You should carefully consider the comparable GAAP measures. Reconciliation of non-GAAP and GAAP measures is included in our earnings release. You can find a webcast of this call and a PowerPoint presentation on our IR website.

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

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

Hello, everyone, and thank you for joining us today. We held our Investor Day in September in Xi'an, China. It was wonderful meeting investors face to face. At the event, we unveiled our RGM 2.0 strategy with a strong focus on growth. We have set ambitious growth targets for the coming 3 years. These include reaching 20,000 stores by 2026, achieving double-digit EPS CAGR and returning $3 billion to shareholders in dividends and share repurchases. With our long-term growth commitment in mind, let's zoom into the third quarter.

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Our results reflect continued strength. Third quarter net new stores, revenue and adjusted operating profit, all reached record levels. We accelerated new store openings with 500 net new stores in the quarter, while maintaining healthy store payback periods. Our portfolio now exceeds 14,000 stores. System sales grew 15% year-over-year in constant currency. Adjusted operating profit, excluding temporary relief grew 21% year-over-year in constant currency. In the first 9 months, adjusted operating profit exceeded USD 1 billion.

Our team's relentless efforts produced these remarkable results. To drive sales in the peak summer trading season, we bolstered crew resources for excellent service, ensured supply pipeline readiness and execute traffic driving campaigns. Same-store sales growth in the third quarter was led by strong transaction growth. During the summer holidays, same-store sales at our tourist and transportation locations surged more than 50% year-over-year. It's important to remember, though, that consumers have continued to be cautious in their spending. Our formula to capture sales growth has always been simple; good food, good fun and exceptional value. Now, let me go through what we have done.

First, food innovation on a big scale. Our $100 million club showcased at Investor Day illustrates our success in building huge categories to boost sales. Recent innovations at KFC include our Juicy Whole Chicken and Beef Burgers. To put things into perspective, in the third quarter, these 2 categories combined exceeded 6% of KFC sales mix. This is higher than our Original Recipe Chicken, which we have been proudly serving in China over the past 36 years. It shows our ability to innovate but also build very big categories.

We are continuing to expand these categories with new flavors like Sichuan-style Spicy Whole Chicken (Chuan Xiang Yan Bang Mi Zhi Quan Ji), offering it from Friday to Sunday only. This Spicy Whole Chicken is perfect for a home consumption. We also collaborate with Ultraman (Ao Te Man) to promote our premium Ultra Cheese 2.0 Beef Burger, (Pu Bu Zhi Shi 2.0 Zhi Zhi Hou Niu Bao). Consumers loved them. At Pizza Hut, we sold over 100 million pizzas in the first 9 months of the year. One out of every 5 pizzas we sold was a Durian pizza, that's over 20 million Durian pizzas, nearly 70% more year-over-year. Our in-house supply chain worked with suppliers to secure Durian supply and expand capacity to satisfy the growing demand.

Second, we are offering our customers amazing value for money on top of the innovative food. KFC Crazy Thursdays, (Feng Kuang Xing Qi Si), is no longer just a marketing campaign. It has become a cultural phenomenon. Crazy Thursday sales consistently outperformed other weekdays in the third quarter by around 40%. To keep customers engaged, we rotate offers and regularly launch new flavor variations such as Spicy Nuggets, (Bao Huo Jiao Ma Ji Kuai). We chose products that utilize existing ingredients and involve simple cooking processes to provide exceptional value while ensuring operational efficiency.

At Pizza Hut, we are expanding our selection for pizzas priced below RMB 50, which is a very significant portion of the overall pizza market. Around 20% of our pizzas we offer are priced below RMB 50, and that's not enough. We could do more. By enriching our lower-priced pizza offerings, we are tapping into this substantial opportunity that is currently underserved by Pizza Hut. Other than pizzas, we are adding new snacks that customers love. Our new Cheese tart, (Zhi Shi Ta) became our best-selling snack in September and an amazing traffic driver, not easy for a snack item to be traffic driver compared to Pizza.

Next, keeping users engaged and having fun along the way. Our loyalty programs topped 460 million members in Q3, up 15% year-over-year. Notably, sales from members continue to be high at 65%. We collaborate with pop culture icons that resonate with young generations. KFC's campaign with Honkai: Star Rail (Xing Qiong Tie Dao), a popular e-game, generated huge social buzz and attract many new customers. Almost 40% of traffic generated from the campaign came from new or inactive members and a significant portion are young adults, and that is fantastic news for the brand.

We were proud to be exclusive western food catering supplier for the Asian Games in Hangzhou. Over 250 of our crew members from across China were chosen to serve at the sporting event. KFC and Pizza Hut set up nearly 30 pop-up stores and served over 1 million athletes and fans, and it showed that our food is good enough and healthy enough for the professional athletes too. We also ran nationwide campaigns, offering exclusive gifts at our restaurants and through our SuperApp in celebration.

In closing, I want to thank all of our teams for their hard work in delivering a strong quarter. Next week, we will hold our RGM convention for our Restaurant General Managers. This marks the first in-person convention for 13,000 attendees since 2019. Very excited about it. It's an excellent occasion to honor our RGM's dedication, celebrate our achievements and reaffirm our goals for the coming year and beyond. Looking forward, the

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growth potential in China remains vast even with moderate economic growth. RGM 2.0 provides us the strategic framework to grow sustainably. Evolving consumer preferences in the post-pandemic environment require us to stay agile and vigilant. Our robust supply chain and innovative digital ecosystem have enabled us to quickly adapt to changing market conditions. I'm confident we can continue to create long-term value for our shareholders.

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

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

Thank you, Joey, and hello, everyone. Let me share with you our third quarter performance. But before I do that, I want to point out foreign exchange had a negative impact of approximately 6% in the quarter. Overall, we achieved solid results, growing across key metrics. On a year-over-year basis, revenue grew 15% and adjusted operating profit grew 10% in constant currency. Compared to pre-pandemic levels, we have a much larger store portfolio. Although same-store sales remained at approximately 90% of 2019 level, system sales grew 22% compared to 2019. With that, let's go through the financials in more detail.

Third quarter total revenues were $2.91 billion in reported currency, a 9% year-over-year increase. In constant currency, total revenue grew 15%. System sales also increased 15% year-over-year in constant currency. The growth was mainly driven by new unit contribution and same-store sales growth of 4%. Dine-in sales continued to rebound year-over-year. By brand, KFC same-store sales grew 4% year-over-year. A strong rebound at transportation and tourist locations contributed to the growth. Same-store traffic grew 9%, while ticket average decreased 5%. These results were mainly driven by successful traffic driving promotions, lower delivery mix and rebound of the breakfast daypart.

Delivery typically carries a higher ticket average than dine-in orders, thus a decline in delivery mix lowered the overall ticket average. Breakfast orders tend to have a lower ticket average as well. So, the rebound in breakfast sales contributed to traffic growth, but lower ticket average. Please note that overall ticket average in the third quarter was similar to the second quarter and higher than 2019.

Pizza Hut's same-store sales grew 2% year-over-year. Same-store traffic grew 12% and ticket average decreased 9%. We want to highlight that by design, we are expanding our price ranges to enhance Pizza Hut's value proposition and to capture their underserved markets. Consistent with Pizza Hut revitalization plan, we want to enhance Pizza Hut's value proposition to consumers. Particularly, we are targeting the sub-RMB 50 pricing range, which represents a very significant segment of the pizza market in China. We also intend to increase the sales mix of delivery and off-premise dining over time. For Pizza Hut, delivery sales generally have a lower ticket average than dine-in. Finally, we aim to bolster the sales of single-person meals. This is a different market segment compared to Pizza Hut's existing customer base, which tends to be group or family dining.

Restaurant margin was 17%, 180 basis points lower than the prior year. This was mainly due to lapping of last year's temporary relief of $30 million, which translates into 120 basis points margin impact. Excluding this impact, year-over-year margin change is only 60 basis points. Wage inflation, normalization of staffing at the store level, and increased promotional activities also impacted margins. On the positive side, Occupancy and Other expenses improved year-over-year, primarily due to sales leveraging and ongoing benefits of cost structure rebasing efforts.

Now, let's go through the key items. Cost of sales was 31.1%, 40 basis points higher than the prior year. We increased promotional activities to drive traffic sales as well as drive sales. And we also faced higher poultry prices in the quarter. This was partially offset by more favorable prices for commodities, including beef and cooking oil as well as full utilization of chicken. Cost of labor was 25.3%, 180 basis points higher than the prior year. Last year, we benefited from temporary relief of $17 million, which translates into 70 basis points margin impact. Two other key factors that impacted labor cost comparison were: one, mid-single-digit wage increase for frontline staff due to annual wage adjustments; and two, normalized staffing levels at our stores compared to the pandemic last year. These were partially offset by sales leveraging.

Occupancy and Other was 26.6%, 40 basis points lower than the prior year, benefiting from improvement in rent and depreciation expenses. We continue to secure more favorable rental terms for our new stores. Lower depreciation resulted from lower upfront investment and store portfolio optimization. It is important to note that 45% of our stores have been built after 2019. This was partially offset by lapping of $13 million in rental relief and austerity measures associated with the pandemic last year. G&A expenses increased 14% year-over-year in constant currency, mainly

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from higher accrual of performance-based incentives, and to a lesser extent, merit increases and higher travel expenses from the resumption of business travel.

Operating profit was $323 million, increasing 9% in constant currency. Excluding $30 million in temporary relief received last year, adjusted operating profit grew 21% in constant currency. Our effective tax rate was 27.5%. We continue to expect our full year effective tax rate to be around 30%. Net income was $244 million and diluted EPS was $0.58, both increasing 18% in reported currency. Excluding the foreign exchange impact, net income increased 26% and diluted EPS, 27% in constant currency. We generated $410 million in operating cash flows and $243 million in free cash flows in the third quarter. We returned $211 million to shareholders in cash dividends and share repurchase in the quarter, on track to return $600 million to $800 million for the full year 2023. Our balance sheet remained strong with around $4.2 billion in net cash position by the end of the third quarter.

Now, let's turn to our outlook. Regarding store opening, we opened 500 net new stores in the quarter and 1,155 net new stores year-to-date. We are on track to meet our 2023 full year target of 1,400 to 1,600 net new stores. The new store payback period for our KFC and Pizza Hut store remains healthy at 2 years and 3 years, respectively. With our healthy new unit payback together with flexible formats and modules, we are confident to reach 20,000 stores by 2026, as we unveiled at our Investor Day. Looking ahead, the fourth quarter is seasonally a small quarter for both sales and profit. On the sales front, since late September, we have observed softening demand, which extended to October. Consumers have become more value conscious. We have been focusing on food innovation and widening pricing ranges to tap into underserved markets to drive growth.

Regarding margins, sales remain the biggest factor. Fluctuation in sales may have a pronounced impact on margins in the fourth quarter. As a reminder, in the fourth quarter last year, we also received $26 million in temporary relief, which we do not expect to repeat this year. We also anticipate wage inflation of mid-single digits and returning to more normalized staffing levels at our stores. Just a reminder, in the fourth quarter last year, we experienced labor shortages due to widespread COVID infections.

The post-pandemic economic recovery is shaping up to be a wave-like and non-linear process. So, we will maintain our focus on driving sales and cost efficiency. However, the overall trend towards recovery is evident this year and many of our performance metrics are setting new records. We have demonstrated our ability to quickly adapt to changing consumer preferences and seize opportunities under different market conditions. We are confident that the successful execution of our RGM 2.0 strategy will help us expand our store portfolio, grow sales and boost profits, delivering sustainable value creation and long-term returns to shareholders.

With that, I will pass you back to Michelle. Michelle?

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

Thanks, Andy. Now, we will open the call for questions. To always give more people the chance to ask questions, please limit your questions to one at a time.

With that, please start the Q&A.

QUESTIONS AND ANSWERS

Operator

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

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Michelle Cheng - *Goldman Sachs Group, Inc., Research Division - Co-head of Asia Consumer Research*

My question is about the competition. Especially you mentioned that the trend turned softer since the end of September. So, can you share with us how do you see the competition landscape evolve? And also, with this value campaign, how should we think about the balance between the top line growth and also, the full cost control?

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

Thank you, Michelle. Regarding the competition, we see it as a positive trend and sign because despite concern towards the macro situation in China in the media, in reality, both international and domestic players are investing aggressively in our industry. That shows that these players, competitors are voting with their money and voting with their feet, and that's consistent to our view towards the business and our industry in China, particularly for the chain store business model. On top of that, we see very vibrant competition in the lower-tier cities. Again, that is good because if you remember back to our Investor Day, we have a very aggressive store opening plan, especially in the lower-tier cities. And that resonates well with our view that there's a lot of opportunity in the lower-tier cities. So, we're quite happy to see that.

And then when it comes to the point about value-driven consumers. We have been a player that has benefited from the more cautious and more rational spending from the consumers. We are a fast food company. When a customer becomes more value-driven, it's good for us. As far as we have the capability to deliver, and we do. And it has been a consistent focus for our company to focus not only on value, but on innovative products and fun experience because value itself is never enough for our customers. And we'll continue to do that.

And you can see that in this quarter, in the past many years, we have been very consistent with our ticket average. With the ups and downs, our ticket average compared to the last sort of more stable year, 2019, is still up a little bit because we are very careful about it. We can see price increases every year, and for Pizza Hut, during the turnaround time for the original product, we kind of kept the price the same, but then we get a bit more opportunity with the new products. But the ticket average has been relatively stable. And even in the last quarter, you can see we had very healthy growth of transaction count (TC). And in our business, TC growth is so good and it cannot be better to have TC growth. So, it shows them we react very quickly, and we are very agile, and we get the sales.

Last, but not the least, while we are doing all these innovative products, we deliver value (technical difficulty). We are able to protect our margin with our innovations and value campaign and that is very important. In fact, our year-to-date margin has already exceeded that of 2019, which is pre-pandemic. There's some movement, and Andy I'm sure, Andy will go through it later on. There's some movement between the different lines of cost structure. But the restaurant margin, that's what we protect. We reduce the rent, we reduce the O&O and we put the money into food and service to serve our customers. So net-net, competition for us is good because we see it's a vote of confidence for our industry and our market. Thank you, Michelle.

Operator

Your next question comes from Lin Sijie from CICC.

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

So, I have one question regarding the margin. So, Andy has mentioned the reasons behind the margins year-over-year change. But if we compare Q3 with the same quarter in 2019, our revenue increased 26%, but operating profit only increased 8%, which is quite different with Q1 and Q2. So, could you please help us better understand this?

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

Sijie, thank you for your questions. And so, as we mentioned, if you look at the year-over-year comparisons, you definitely need to take out the impact from the temporary relief last year. And when we compare to 2019, obviously, over the past few years, we continue to see the labor cost

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that was increasing over the past few years. But we're able to partially offset that by improvement in our O&O, which is occupancy and other expenses.

And then if you look at it by item, you see that COS is actually pretty stable, around 31%. Our COS, as mentioned, because of wage inflation and a higher mix of delivery, we have seen some increase there. However, on the O&O side, we are much better, mainly benefiting from store portfolio optimizations and rent negotiations and better lease terms, and we also have other initiatives to rebase our cost structure to possibly offset that if you look at the same-store sales, which is about 90% level of the 2019.

Now looking at -- as we mentioned a little bit earlier, looking ahead in the fourth quarter, fourth quarter is a smaller quarter for us in terms of sales and profit. And so as we have mentioned, we have seen some softening demand in September. So, sales fluctuations will have a more pronounced impact on profitability and margin. Now again, in the fourth quarter compared to last year, last year, we received $26 million of temporary relief, which we do not expect to repeat this year.

Now, you have wage inflation, let me just repeat it again, mid-single-digit wage inflation, normalization of staffing levels at our stores. Longer term, as we have mentioned at our Investor Day, we -- our goal is to maintain a stable margin and potentially improve it over time. Obviously, we have to work hard to continue to offset wage inflation impact every year and potentially commodity inflation in the long term. It's important to keep a short-term and long-term balance in mind. We will continue to benefit from cost structure rebasing efforts that will stay in place for a long time. For example, high levels of variable rent, our "Mega" restaurant staff sharing program. We also have more flexible and lower investment from our store model. So, we will maintain our discipline in cost efficiencies and also continue to improve productivity. That's how we look at the margins in both short term and long term.

Operator

Your next question comes from Christine Peng from UBS.

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

Thank you, management. I actually have a question, which is also related to competition, but I want to ask more details specifically in terms of this Chinese-style burger. I think in the Investor Day, in Xi'an, your KFC management actually shared with investors KFC's plan to launch the Chinese style burger products in the very near future. So, can management share with us the timetable as well as more specifics about this product in terms of price strategy, product strategy going forward?

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

Thank you, Christine. We actually have test launched this particular product in 3 provinces already, Jiangxi, Fujian in particular. So, it's interesting that we test launched it in -- not in Guangzhou, Beijing or Shanghai. We do it in sort of the second-tier cities. And the progress has been good and we are happy with the result and we continue to work on our plan and then move to next stage when we are ready. The price point is competitive. It's very affordable. And it's one of our strategies that for the lower-tier cities, we have slightly different products and more accessible pricing. But at the same time, we still maintain the margins for the business. But it's going well. I have tasted the product myself. It tastes great. So hopefully, next time, we can get it closer to Hong Kong, where you don't have to travel that far to try it. Thank you, Christine.

Operator

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

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

So, my question is also on competition. In fact, last time in Xi'an, I also raised a question on Tastien and the likes of TikTok coupons. And I think given our current value campaign and our initiatives to broaden our price range as well as to sell more coupons on TikTok, do we think that the ticket average decline that we saw in Q3 could actually extend into the coming few quarters? And would the ticket count increase can be enough to offset the average decrease? Lastly, in terms of our food paper cost as a percentage of sales, do you think that in the near term, it could be under some pressure on a year-on-year basis into the coming few quarters?

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

Let me just point out that the ticket average compared to last year is not exactly the best comparison because last year is during the pandemic, ticket average is unusually high because people lockdown at home. And when they order, they order big ticket size, right? What is more comparable is we look at the ticket average compared to sort of the more normal year, although we were -- our business is very different compared to 2019, but we can compare the ticket average with 2019. The ticket average is still slightly higher than 2019. So, that is sort of more normal. So, I asked our investor not to be overly concerned about the ticket average drop compared to last year.

And usually, when our sales move, more focused number is always transaction, TC. And the fact that our TC grew at almost double-digit is a good sign. So, in our business over many, many years, just go beyond 1 quarter, go through the 5 years or 10 years, you will see our ticket average is always rather stable. So that's hopefully, address your concern about the ticket average. And go on.

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

Yes. Let me just address both TA. As I tried to in the prepared remarks try to compose what is tracking the TA. Obviously, promotion is a part of that, but it's a very -- it's only one of them, right? If you look at, for example, for KFC, today, the TA is still higher than what we have seen in 2019 as Joey mentioned. And part of that is delivery mix, right? We have higher delivery mix compared to 2019. And then if you look compared to last year, we will decline, or decline in the mix for delivery, as people returning to the store. And so that will have an impact on the TA because the delivery TA for KFC obviously is higher than the dining component.

The other one is if you look at KFC, for example, we also mentioned about breakfast daypart, right? So, last year, it was the pandemic, the breakfast daypart was impacted more so than the other dayparts with the rebound in breakfast daypart, which tend to also have lower TA. So, the increasing traffic for breakfast daypart would also impact on that. So, there's a number of components. And if you look at our COS, you will notice that it's actually very stable, right, compared to last year, only 40 basis points difference. Compared to 2019, 10 basis points, it's almost flat line, right? So, we have ability to manage the overall our profitability, our margins with different drivers for TA.

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

Just coming back to food paper cost, I mean I think we have shared in our Investor Day that we've been managed -- we've been able to manage the food paper costs at a very stable number over many years. When there are some factors driving up the food cost, well, such as commodity inflation, we are able to deliver a very stable cost because of our innovations and using all parts of the chicken and being flexible with our supply chain. So, we are always quite stable here. And I keep reminding our team internally, the problem, the food paper cost become a problem is when it becomes too low. That means that we are not giving the value for money, the quality of food and the volume of food to customers. So, it's relatively stable percentage for the food paper cost over the many years.

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

Yes. Thank you, Joey and Andy. So, we also have confidence in the management ability to stay agile and take the right measures to address competition and further reshift.

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Operator

Thank you. Your next question comes from [Lillian Lou] from Morgan Stanley.

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

This is Lillian from Morgan Stanley. Can you hear me?

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

Yes.

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

Yes. So, I have a question again on margin side but in different aspects. I think despite all this losing the subsidy impact and normalization of labor staffing to stores, is there any impact from acceleration of store expansion to margin? Because I think going forward, we're going to keep up this expansion pace. So, should we kind of think about the margin base, given such a situation? Just wanted to maybe kind of get us some color on how to quantify the impact of faster unit expansion to margin.

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

Thank you, Lilian. So, when we look at our net new store opening, they continue to be very healthy. If you look at the overall cash payback period for our new store opening, is still 2 years for KFC and 3 years for Pizza Hut. In fact, as we mentioned, the smaller store model actually performs even better. Now, if you look at how they ramp up, obviously, there's a ramp-up period for the newer stores. We have mentioned the vast majority of our new stores actually break even in the first 3 months and they're going to ramp up through the year. It may have a short-term impact when it just open because it's ramping sales and margins tend to be lower, but they tend to be very healthy unit economics, as they progress into a year or two from the opening.

So, we -- there's no change in the way we look at store openings in pointing the important indicator for us is to look at how the new stores are performing in terms of cash payback, in terms of unit economics. And as long as those are good, we will continue to stick with our plan. And as we mentioned, we have been very disciplined about store openings, driven by our investment model and then also some ground up from our market. So, we have acceleration based on the performance of the store.

Your next question comes from Anne Ling from Jefferies.

Anne Ling - *Jefferies LLC, Research Division - Equity Analyst*

The question is regarding the current trading environment. You guys mentioned about like being a little bit softer and with like sales fluctuation. Would you like elaborate a little bit on that? Is it like you're talking about like post-festive events that there is a fall-off in terms of sales performance regardless of like any like promotion or innovative products that you launched? Or is it because a certain daypart that you noticed that didn't really like perform as expected. Maybe or certain geographical area, we'd love to hear a little bit more about like what drives the softness? Is there anything that we can do about that, yes?

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

So -- at the high level, I mean, summer was vibrant, particularly in July, there's some pent-up demand. So, as I mentioned earlier, transportation hub traffic increase 50% year-over-year, which is really a good sign. And then it comes to the just recent national holiday during the first half of October, it's quite interesting here, actually, we observed sort of first half and second half during the national holiday. Because this year, particularly this year, the national holiday at the beginning is, at the same time, as Mid-Autumn Festival. So, we saw softness during the first half because after 3 years pandemic, Mid-Autumn Festival. For Chinese people, what do we do? Go home.

So, the first half of the holiday, we saw massive number of customers going home, go back to see their family, spend time there. So, the demand was soft. And then by second half of the holiday, after seeing mom and dad, I think people decided -- still decided to travel a little bit. So, the second half of the October festival actually the traffic picked up. So, there's a little bit of this natural human behavior happening during the national holiday during Mid-Autumn festival. That's the point one.

And point two is in terms of the consumption, cautious spending, we do see customer spending a bit less on the premium product, although our premium burger, our premium product in pizza still are doing quite well, but there's a little trend going. And then it comes to the third point is what are we going to do about it? Well, we have been working on, and we have been doing it quite well, actually, with pretty good result, is widening the price range. So, it's still only the bottom, the top end, because we serve a very large customer base, and there's always some customer who want to treat themselves. The same customer who want to treat themselves during festival time. So, the premium Beef Burger, et cetera, we do that.

But at the same time, we also enrich entry price offering. Pizza Hut, the pizza, is a good example. We have a sort of single-digit revenue coming from pizza, below RMB 50. And in fact, this is a very big segment for both international and domestic players. We see this as a big opportunity here. So, you can imagine, we have more and more products in this particular segment. Not only the below RMB 50 pizza, but also single person meals. Because for Pizza Hut business, our business model, our average number of customers per transaction is over two people. Well, that shows that we have the opportunity to serve the one-person meal as well. And we see good progress in it and we could do more and get more market share in the 1-person meal sector.

And then for KFC, we also continue to work on the choices of products at the entry price offerings to capture untapped potential of customers, particularly those in the lower-tier cities. So, we can operate at a wide price range all the way to Tier 6 cities. And that's what we do. And therefore, we see very good traffic growth. On top of that, in terms of the dayparts, weekdays are still doing better than weekends. And why, the weekend traffic is still a bit soft and that has a lot of reasons behind it.

But the point is our focus on the Whole Chicken, which is mainly at-home consumption product, our focus on certain other products to support the weekday traffic, we're doing the right thing and we see very good results from customers. And therefore, for Quarter 3, we delivered record revenue, record profit. But of course, the biggest challenge for us is the foreign exchange that eat up 6% of our revenue and profit, which is a problem. But in constant currency, we have been doing quite well. So, we will continue to focus on the few things that I mentioned, really good products and very good price and good experience, but still protect the margin for the investors and shareholders.

Anne Ling - *Jefferies LLC, Research Division - Equity Analyst*

And can I ask another question regarding the franchise business. We talked a lot about this during the Investor Day. Can you share with us the latest update with your captive franchise, i.e., like those specialty -- those hospital, uni and also like the highway centers? When will we see the ramp-up on the franchise business?

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

Right. So, if you like, to be quick about this one. As we look at the third quarter, for example, our franchise -- number of new franchises -- is growing pretty fast, it's like 20%-plus compared to last year. And so for new store openings. So, I think we're making progress there. But obviously, things is not going to happen overnight. [It's going to continue to ramp](corrected by company after the call). So, that's how we look at it.

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Your next question comes from Ethan Wang from CLSA.

Ethan Wang - *CLSA Limited, Research Division - Research Analyst*

So, my question is on same-store sales. So, we see that ticket drive at KFC and Pizza Hut declined, but that is understandable with China's consumption space and consumption space competition. And yes, it's good to put more promotions to have more traffic. So, it's always a balancing act. But I just wonder, if we decrease ticket sales and maybe price hikes on the traffic, is that going to, like, cause some pressure on future margins, especially from labor because with more people, we need to have more staff, but we have more orders, ticket price comes lower. We understand there's the impact from the delivery, but I just wanted to understand would you have some more color on the thinking on this trend going forward.

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

Okay. So, let me try to address that. So, in terms of the TA, I think you have a couple of questions concerning TA, let me try to help folks understand a little bit more in detail. Again, if you look at, for example, the KFC TA shift, there are 3 key components to it. Obviously, number of people have mentioned traffic-driving promotion activity. But that's only part of the story and is not even main part of that. We also have the lower delivery mix shift, right? So last year, during academic, we have seen very high delivery and when the delivery come back, especially what we call like group ordering delivery last year, right, group buy delivery. And so when, this year, when things return to more normal, we do see the delivery mix to be slightly lower than last year. And so that's normal because people are coming back to the store. And so that's about impact.

The other one is, as we mentioned, there's some dayparts, right? They also shift, would also have an impact on that. For breakfast, as we mentioned, generally, we have a lower TA. And so when that is growing faster, then you would also see a TA impact on the overall KFC TA. I think for Pizza Hut, maybe slightly differently as we have mentioned, because of the promotion activities, we are actually by design, trying to target untapped market, which is below RMB 50 segment, which is very underserved by Pizza Hut, but it's a very big part of the pizza market overall, which is, obviously right now, a number of players are active in there. So, we want to penetrate that market.

The other one for TA for Pizza Hut, as Joey mentioned, is our purposeful targeting of single-person meal sets. Pizza Hut, well, KFC, if you look at the TA and then you have Pizza Hut, you will see that Pizza Hut has always had high TA. And then a part of that is because it's in group dining and also in family dining. So, when we have product that's designed particularly for single person mean set especially working lunch and whatnot, you're going to see the TA shifting there. And finally, if you look at even before the pandemic, we have done a purposeful job to actually increase the value proposition to consumers.

One of the biggest challenges and for Pizza Hut before their revitalization program was that their value proposition to consumers. And so we've been working very hard and hold the price stable and whatnot to drive that. And so that's why by design we're doing that. Because when Pizza Hut is going to try to expand and address a bigger customer base, you're going to have a wider pricing range. And so that's why continue to expect TA over there has a movement there. So, there's a lot of components there by our strategy.

But the key point is that despite all that stuff that's going on, you see that our COS very stable, 31%, right? Because we have product innovation. We have a very strong supply chain managing that. So overall, that's how we want to keep a balance between driving the traffic, expanding our addressable market, and at the same time, maintaining our TA. Now obviously, for COL, the biggest concern on their long term is the demographic change in China and whatnot. And so it's very important for us to continue to invest in automation, digital, and to improve our operations so that we can continue to improve the labor productivity of our workforce. And we've been quite successful doing that before the pandemic and coming out of the pandemic, we're also pretty stable at about 25%, 26%. And that's the thing that, long one, as you mentioned, trying to maintain the overall margins and expand it potentially over time.

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

Maybe I'll just add some color on the COL side in particular. If we look beyond just one quarter, we look at our COL over the last few years, as we shared in our Investor Day, when we have a few thousand stores, 6,000, 7,000 stores, we have 430,000 people or 450,000 people actually. Now we

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have 14,000 stores, almost double, and we still only have 430,000 people. So as Andy mentioned, we use automation, digitization to manage labor cost.

When it comes to sort of more -- when it comes to handling the promotion and while managing the COL, well, as I mentioned in my prepared remarks, we tend to pick those products that utilize the existing ingredients and that they are very easy to make. And we're very careful about maximum number of items that the staff can handle in our store. And that's why having an amazing, I would say, second-to-none operation team is important. We do have pretty dedicated and a good balance of how many items we sell in the store and what is the impact on the COL, and most important was the quality of food that we can protect in order to deliver in the short term and long term.

Operator

Your next question comes from Xiaopo Wei from Citi.

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

I have a quick follow-up question on restaurant margin. In the third quarter, do you see any widened divergence of restaurant margin of high-tier city versus low-tier city? And also, Andy, in the prepared remarks you explained a lot about we are having concession rent for new stores, et cetera. Looking forward, shall we expect our occupancy and other expenses-to-sales ratio to keep low because in the past 2 years, this has been a very good factor to mitigating other inflation component in the restaurant market?

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

Thanks, Xiaopo. So in terms of the difference and variance, I think there's not material changes to the way margin actually pan out, as we have mentioned before, obviously, in Tier 1 cities, Tier 2 cities, the high-tier cities. Generally, those still have higher throughput at the store. But generally, you have a slightly lower margin because higher cost, labor and rent. And then in lower-tier cities, although you have a smaller throughout through the store, generally costs are lower, labor and all that. So, the margin is slightly higher in the lower-tier cities. But all-in-all because also their investment, upfront investment is different in different tiers. So, we end up -- have a pretty good payback period for both top-tier and lower-tier cities. And so that's in terms of the variance between margins in different tier cities.

Now in terms of O&O, I think as we have mentioned, obviously, last year, we had some temporary relief. But all-in-all, like O&O, even including those you see continued improvement there. Those contracts are longer-term contracts and when you get favorable long-term lease, you got favorable long-term impact. And then we also have other cost structure initiatives and portfolio optimization. So, I think O&O improvement would stick. But obviously, that's also limits in terms of how low we can get, no one is going to give you free rent. But I think in the long run, I think we'll continue to be pretty healthy for O&O as a percentage of sales.

Operator

There are no further questions at this time.

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

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

Good-bye.

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

Thank you.

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

Thank you.

Operator

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

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