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YUMC - Q2 2018 Yum China Holdings Inc Earnings Call

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OVERVIEW:

Co. reported 2Q18 total revenues of $2.1b.

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to Yum China 2018 Second Quarter Earnings Conference Call. (Operator Instructions) I must advise you that this conference is being recorded today, 2nd of August 2018. I would now like to hand the conference over to your speaker today, Ms. Millicent Tu. Thank you. Please go ahead.

Millicent Tu

Thank you, operator. Hello, everyone, and thank you for joining Yum China's Second Quarter 2018 Earnings Conference Call. Please note that a PowerPoint presentation and the live webcast of this call are available on our IR website under the Events & Presentations section. Joining us on today's call are Ms. Joey Wat, CEO of Yum China; and Jacky Lo, CFO of the company.

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

This presentation also includes certain non-GAAP financial measures. You should carefully consider the comparable GAAP measures and reconciliation thereto.

Today's call includes 3 sections: First, Joey will discuss Yum China's second quarter 2018 highlights; and Jacky will discuss the financial results. We will then open the call to questions.

At this time, I would like to turn the call over to Ms. Joey Wat, CEO of Yum China.

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

Thank you, Millicent. Hello, everyone, and thank you for joining us today. I would like to begin with Slide 4, providing a few high-level comments before going to details. Overall, we are leveraging our strong fundamentals to invest proactively for long-term growth. We are building capabilities in delivery, digital and data across all brands for a sustainable platform. We observed some softness in consumer spending and competitors increasing promotional activities, focusing on value. Despite the challenges, we achieved profitable growth in the second quarter of 2018.

We continue to return value to shareholders, distributing over $110 million in form of dividends and share repurchases during the past quarter. KFC achieved robust system sales growth lapping 2 strong quarters in 2017 and 2016. Supported by healthy brand fundamentals, we accelerated KFC new builds and will continue to explore new ways to grow different dayparts and categories. We aim to serve our customers faster and better.

Pizza Hut remained challenging, but we are executing the key aspects of the revitalization plan. With smarter investment and cost control, margin is better managed in the second quarter compared to the first quarter of 2018.

Next, I would like to discuss the performance by our key brands. We'll start with KFC on Slide 5. Our knowledge of the local culture, capability in connecting with customers and product innovation, first-class execution and over 5,600 stores nationwide now continue to give us confidence in strengthening our leadership in the QSR sector.

Second quarter system sales grew by 5% year-over-year and 7% year-over-year in the first half of 2018, thanks to KFC's very strong fundamental and excellent execution. Encouraged by the long-term potential in China, we accelerated new store builds by adding 272 stores in the first half of 2018. That means 63% year-over-year growth rate of new builds. Lapping strong quarters in 2017 and 2016, second quarter same-store sales was flat. On a 3-year basis, the same-store sales CAGR was 4%, which we believe was a very healthy rate given our large size.

Restaurant margin declined slightly to 16.8%. This was partly due to inflation and investment in product and promotions to drive top line. With the robust system sales growth, our operating profit grew 2% year-over-year in Q2 and 8% in the first half, both excluding foreign exchange. Jacky will provide more color later on.

Looking to Slide 6. In Q2, we continued to offer exciting products, strengthening the emotional bond between KFC and our customers. To stay ahead of competition, we proactively increased -- invest in product upgrades, offering customers better value and bigger savings, which will help us build a stronger loyalty program in the long term. We started April by featuring a very successful beef wrap campaign, which is something that we have launched few times throughout the history of KFC. And we also launched the signature wing bucket window, which drove good traffic to our stores. Interaction with customers generated strong social buzz.

In May, we launched devil's chili crispy chicken catering to younger generation craving for the stronger sense of spiciness. Building on the success of last year, we upgraded and relaunched Chizza in June, which received very good feedback from our customers, especially the younger customers.

Going to Slide 7. Bucket has become one of KFC's signature products for families and friends to celebrate together on key festivals and holidays. To bring excitement to our consumers, we keep refreshing offerings with customized design for different occasions. Now during Labor Day holiday, which is a very popular holiday for people to get on trip, we launched (foreign language). That in Chinese means good buddy, but it's also the iron bucket, good buddy themed bucket emphasizing the importance and value of friendship. It was the third year that we celebrated Dragon Boat Festival, our upgraded rice dumplings, zongzi, featured a popular ingredient, which is salted egg, and that generated strong sales compared to previous 2 years. So we launched the zongzi last year, the rice dumpling but then we add something new, which is (foreign language) to excite the customers.

Children's Day is more than a festival for kids in China. It has become a family party occasion. The fun and hospitality that we offer to our consumers in return generate better sales compared to the previous 2 years. To celebrate this year's World Cup, we also partnered with a beer sponsor and extended our business hours to accommodate late-night demand.

As discussed in Q1 2018, breakfast, coffee and dessert are our key growth areas. We are on Slide 8. Our innovation is inspired by having trendy, desirable and fashionable elements to normal good food that people can afford.

For breakfast, we launched sao bing. It's a traditional northern China pancake, and a new rice roll with additional touch of salted egg. You can see salted egg is really a very popular ingredient in China right now. It's a (foreign language) product. Both products are widely welcomed by our consumers, although they are sold at a slightly higher price than our normal KFC price.

Coffee is an exciting category for KFC, and we are well positioned to expand using our extensive network. In Q2, we launched new coffee flavor targeted at younger consumers, and that is sparkling coffee, is one of our popular products, which younger customer like quite a lot. It's more like a drink than a coffee for them. Over 40 million cups of coffee were sold in the first half this year. That means 2.5 cups of coffee per second that was sold in KFC China, and making us one of the largest coffee retailers in terms of number of cups sold in China.

On dessert, ice cream is a great product to attract new customers because it's very low price point. We offer high-quality and fashionable product, you can see from the picture there, at very affordable prices such as Okinawa sea salt and lavender ice cream, and they were very, very popular. On top of the seasonal ice cream flavors, we also enriched ice cream toppings and waffles offering.

I would like to touch on KFC digital and delivery progress on Slide 9. We maintained our leadership in digital and delivery in our industry, and our previous investment yield strong result. KFC loyalty members exceed 135 million, which is up 50% compared to the second quarter of 2017. Member sales represent 45% of our sales now. It's up 12 percentage points from Q2 last year. Preorder reached 28% of our sales in the second quarter, up from just 11% a year ago. Preorder's improved operation efficiency enable us to track and understand user behaviors better.

Delivery continued to be a key sales growth driver, especially in the low-tier cities. In the quarter, delivery represents 13% of sales, up 33% year-over-year. Our delivery service coverage has exceed 1,000 cities, covering 68% of our stores. We are working on initiatives to drive the next stage of growth, including growing under penetrated dayparts and categories, improving rider efficiency and Delivery Prime program. For KFC, we have stores in 1,200 cities, so even just from city coverage alone, we still have some room to grow.

Quickly, the next slide is a picture of our restaurant featuring a new store design for Pizza Hut. This is a real picture, not Photoshopped. Apart from good food at good prices, dining ambience is crucial for casual dining.

Turning to Slide 11, I would like to discuss Pizza Hut's overall quarterly performance. To recap, the revitalization plan consists of investments in food, CRM and delivery, which will benefit Pizza Hut over multiple years. Despite short-term impact on sales and margin, we are accelerating remodeling and closing some stores as necessary to rejuvenate Pizza Hut.

With additional new management members, we are fully dedicated to revitalizing the brand, restoring traffic and improving sales. Revitalization is never easy and can be bumpy, and we will continue to have challenges. But despite the obstacles, margin management tightened, and we will continue to invest smarter down the road, which Jacky will elaborate more later on.

Turn to Slide 12. Fundamentals, digital, delivery and multi-format stores have been the 4 key pillars of Pizza Hut revitalization plan. Given our scale, it needs to reach critical mass for all of these pillars to work effectively together. We have made some great progress along the journey.

First, we have been improving food, ambience, service and value. Menu has been streamlined for different dayparts, and productivity has improved. Store remodeling will be accelerated to roll out our new store design.

Second, to connect with our consumers, we launched waves of digital and targeted marketing, and Pizza Hut is turning increasingly trendier. In less than a year, Pizza Hut made good progress in strengthening its digital capabilities.

Third, we are improving our delivery capability and growing our delivery sales on aggregators and own channel. Finally, we will continue to experiment multi-format strategy including bistro, small store and express. 40% of our new builds this year are expected to be in these new formats. Meanwhile, we are also adjusting our store seating to optimize sales at peak hours in higher tier cities.

To compete effectively, we will be deploying regional strategy [as well], for example, offering more aggressive value campaigns in southern and northern part of China. All of the above are still work in progress. We will continue to report progress on future calls.

Moving to Slide 13. Food with good taste and value is our top priority, but Instagram-worthy look and the uniqueness are also important to drive social buzz, expanding younger customer base. In April, we successfully had our menu revamp, which featured 18 new products and 4 upgrades such as smoothies, omelet rice and salad series. The new menu successfully drove ticket average increase. It's also worth mentioning that omelet rice drove a lot of buzzes on social media. In Chinese, it's called dan bao fan.

Since 2017, over 60% of our menu has been changed or upgraded. A proportionate percentage of sales were contributed by these products in the quarter. We will continue to focus on food innovation going forward.

Turning to Slide 14, which features the campaign that we carry out in the second quarter. We adjusted our marketing campaigns to focus on product with more sort of a mass appeal in Q2. We narrowed the campaign window for black truffle pizza back in April because that still sort of the -- a bit of -- towards the niche segment, and we focused on Pizza Air, which is very, very thin. It only has the thickness of 3-millimeter crust, and that targeted a very large customer base with an attractive starting price of RMB 59. It was followed by signature every day half price campaign to promote good value for money. With a smart combination of product offering, the campaign drove incremental traffic while protecting ticket.

Consumer scores on product taste, value for money and repeat purchase intent improved sequentially. As a pizza expert, we will strengthen this image with expanded choices of dough. So now we have the pan. We have the (foreign language) [SCP]. We have the thin crust, and we also introduced the new thinner dough, which is significantly thinner than the pan back to early July.

Turning to Slide 15, a quick review on our digital and delivery efforts. We are pleased to report that Pizza Hut members exceed 45 million, up 80% compared to the second quarter last year. Our member sales increased tremendously to 46% from just 6% in Q2 2017. We believe our investment in digital will enable us to understand our users better, serve them faster and on a more personalized manner in the coming few years.

Pizza Hut digital capability is catching up and its Super App has accumulated 11 million downloads in less than a year of launch. We invest in our loyalty program, integrated loyalty point between KFC and Pizza Hut, and recently, we also launched in-store table-side ordering through mobile phone across most of our store, but we just launched it in early July 2.

During the past quarter, delivery accounted for 24% of Pizza Hut sales, up 18% year-over-year. We will continue to grow delivery sales through aggregators and own-channels.

To sum up, while the recovery is still in the making, we remain fully dedicated to revitalizing the brand and restoring traffic. We are confident that with more innovative products, new store formats and digital and delivery driving better connection with customers, we will be able to drive stronger performance of Pizza Hut in due course.

With that, I will hand over the call to our CFO, Jacky, who will discuss financial performance.

Jacky Lo - *Yum China Holdings, Inc. - CFO, VP & Treasurer*

Thank you, Joey. Good morning to those calling from Asia, and good evening to those calling from the U.S. Let's take a look at our second quarter 2018 performance on Slide 17.

We accelerated our new build openings by adding 164 in the second quarter and 367 in the first half, mainly under KFC. That is equivalent to 2 stores per day covering all city tiers in China. Our portfolio reached almost 8,200 restaurants as of the quarter-end, representing 6% year-over-year growth.

Supported by new build, system sales grew 3% year-over-year in the second quarter and 5% in the first half before foreign exchange translation. Total revenues reached $2.1 billion in the quarter, up 5% year-over-year ex FX.

Operating profit increased by 5% year-over-year ex FX, primarily due to moderate top line growth and G&A optimization. We are committed to returning excess cash to shareholders. In the second quarter, we returned over $110 million to our shareholders, including a cash dividend of $38 million and common stock repurchases of $73 million.

Slide 18 analyzes the key moving parts behind our operating profit in the second quarter. Overall, our operating profit increased by 5% year-over-year, ex FX in the quarter. The key positive operational factors include net new unit growth and G&A improvement. To be specific, 86 net new stores were added in the second quarter, led by KFC. G&A expenses were reduced by 22% year-over-year in the second quarter. We revisit our cost structures and policies to make the organization more efficient. We'll continue to actively manage G&A expenses effectively to achieve our long-term goal of a G&A growth rate lower than the revenue growth rate.

Same-store sales had a deleverage impact on the operating profit in the quarter mainly due to Pizza Hut. Wage inflation was up 6%, and commodity inflation was up 1% in the second quarter comparing to the same period last year. We expect wage inflation at high single digit and commodity inflation at low single digit for the full year.

We continue to put investment in Pizza Hut but reduced the amount to $15 million in the second quarter from over $20 million in the previous 2 quarters. Foreign exchange translation positively impact our operating profit by $14 million in the quarter. Anticipating renminbi to be weakened, such positive impact may diminish in the second half of this year.

Slide 19 provides an overview of KFC financial performance. Second quarter 2018 same-store sales growth was flat, lapping 2 strong quarters in 2016 and 2017, which was 7% and 4%, respectively. As Joey mentioned, 3-year CAGR was 4%, which we believe was a healthy rate. With the support of new builds, KFC delivered year-over-year system sales growth of 5% in the second quarter and 7% in the first half. In this quarter, ticket average increased by 4% year-over-year on the back of our continuous product innovation and upgrade. Traffic decreased by 4% year-over-year due to consumption softening and increased competition. Restaurant margin declined by 0.7 percentage points comparing to the same period last year, primarily due to inflation and investment in product and promotions to drive sales and was partially offset by labor productivity gain. Second quarter 2018 operating profit improved by 10% year-over-year or 2% ex FX, and first half 2018 operating profit improved by 16% year-over-year or 8% ex FX.

Now let's move on to Pizza Hut on Slide 20. Pizza Hut remains challenging revitalization is in progress and it takes time due to our scale. The second quarter 2018 year-over-year sales and margins declines narrowed comparing to the first quarter 2018. System sales declined by 1%, and same-store sales were down 4%. Negative same-store sales growth was primarily attributed to a 6% decline in transaction, offset by a 2% improvement in ticket average. Fundamentals such as brand image, product offering, food and service quality and physical assets all need to catch up to meet consumer expectation. We are making efforts on these fundamentals to restore traffic.

Restaurant margin declined 3.7 points year-over-year. The key factors include 3 points in food investment and promotion, wage inflation and sales deleverage offset by productivity improvement. Food investment is part of the brand's revitalization strategy, and we will continue to invest in product upgrade but in a smarter and more disciplined manner.

Operating profit was $20 million in the second quarter and $54 million in the first half of 2018. The year-over-year decrease was mainly a result of sales and margin decline.

Now let's turn to Slide 21, which is on our development progress. We continue to expand into new cities and further penetrated in our existing cities, covering both high and low city tiers. We opened new restaurants across every city tier and in different trade zones on an accelerated pace. Our new restaurant openings reached 367 gross new units and 215 net new units in the first half of 2018. Over 95% of the net new units came from KFC.

With our strong demand capability, our new unit return remained stable. Across all city tiers, the average new restaurant's pretax cash payback is 2 years for KFC and 3 to 4 years for Pizza Hut. We believe that China continues to offer great opportunities for unit development, and we are uniquely positioned to capitalize on the long runway for growth. For 2018, we maintained new store opening target of 600 to 650 led by KFC.

Slide 22 highlights the powerful business model of Yum China, which is our ability to generate substantial free cash flow. During the first half of the year, we generated net cash from operations of $819 million and free cash flow of $589 million after subtracting $230 million in capital expenditures. Our balance sheet remained strong with over $1.5 billion in cash and short-term investments.

In the first half of 2018, we returned $150 million to our shareholders, including cash dividends of $77 million and share repurchases of $73 million. We will continue to assess opportunities to increase shareholder value given the long runway for growth in China and our strong cash generating ability.

With that, I would like to return the call to Joey to summarize and discuss our future strategies.

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

Thank you, Jacky. Our long history of doing business in China, decades of know-how and people-oriented culture have built a solid foundation for Yum China. That foundation enable us to invest and capture more growth in the future. Both KFC and Pizza Hut are household names in China. While we work to strengthen these core brands, we will continue to nurture smaller and emerging ones such as Taco Bell, Little Sheep and our latest coffee store, Coffii & Joy; leverage our capabilities in delivery, digital and data. And we invest for long-term future growth.

Turning to the last page of our presentation. I would like to conclude the call -- the presentation by emphasizing Yum China's vision to become the world's most innovative pioneer in restaurant industry. We are confident in our business model and its long-term prospects. Each of our 460,000 employees is making an effort, working hard towards this goal.

With that, I return you to Millicent to commence the Q&A. Millicent?

Millicent Tu

Thank you, Joey and Jacky. We will now open the call for Q&A. (Operator Instructions) I also want to quickly touch on recent media stories and market rumors around our business. As you may know, as a matter of policy, like any public company, we don't comment on rumors or speculation. Our board and senior management team remain focused on creating value for our shareholders. We are here today to discuss our performance and outlook and ask that you keep your questions focused on these topics.

Operator, please provide the instruction for Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from the line of Lillian Lou from Morgan Stanley.

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

I have 2 questions. First is on KFC. I think the second quarter is a little bit surprising that margin is also under pressure. So can Joey explain a little bit more in detail in terms of the strategy, how much we invest for growth? Understand that in terms of same-store sales, we're on a very high comp, but going to next quarter, it's a quarter we are probably even on a higher comp. I would say could you provide us what's the same-store sales growth for KFC in third quarter 2016? Because we understand third quarter 2017 was 10%. Second question is on Pizza Hut. The delivery growth was at 18% in second quarter, so it was a little bit more slowed down in terms of the pace versus first Q. So understand that we are in the process of integrating dining in and delivery service. So what are we looking for in terms of rejuvenating the delivery growth for Pizza Hut?

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

Thank you, Lillian. For the KFC Q3 number, you -- I'm sorry, are you asking for the 2018 or 2016?

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

So there's 2 parts of the question, first for trying to understand our KFC strategy because the second quarter margin was declining on a year-on-year basis, so we're trying to see what's the strategy going forward and what the impact on the margin. And the second part is on the same-store sales growth. So third quarter last year was 10%. What was the number in third quarter 2016 on the restated basis?

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

Let's try one by one. So let's focus on the sales, and then Jacky can answer the margin question. So the KFC, we are lapping 2 very strong quarters in 2016 and 2017, and the number was 4% and 7% for the 2 years' Q2 number. And that represent 4% of CAGR on 3-year basis, which we believe was very healthy growth rate. For our business, the ultimate test of our belief in our fundamental is how many new store we'll open as well. So based on our -- strength in our fundamental, we accelerated new store opening last year and we continued the new store openings this year, so in a short term, actually put pressure on our same-store sales but we believe it's absolutely right thing to do given our leadership in the market and our ambition to maintain the leadership and also market share in the long run. So for the Q2, certainly, it impact our same-store sales, particularly in the lower tier city, where we open store very, very aggressively in the -- in China. So for margin, I'll pass it to Jacky. Then, I'll come back to the Pizza Hut.

Jacky Lo - *Yum China Holdings, Inc. - CFO, VP & Treasurer*

I think, Lillian, you're asking for 2016 Q3 same-store sales growth rate on a restated basis.

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

Yes.

Jacky Lo - *Yum China Holdings, Inc. - CFO, VP & Treasurer*

That's negative 5%. That was negative 5%.

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

Negative 5%, okay.

Operator

Your next question comes from...

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

Sorry. Sorry, Davina. We do have the Pizza Hut question. Okay. Lillian, for the Pizza Hut question, for the delivery, so let's take a step back. The delivery for 2017 for Pizza Hut was also very, very good growth because we had the rapid rollout of the delivery service to all the stores in Pizza

Hut store back to 2017. And also, we benefit from the aggressive promotional activities partly sponsored by third-party aggregators. So right now basically for 500 cities in China for Pizza Hut delivery service, we are having the delivery service already. That compares to KFC. KFC by now, our delivery service coverage was in 1,000 cities. That was about 68% coverage. So Pizza Hut, within 2017, we just covered 100% very, very quickly because we can deliver, right? But that gives you sort of the background, the opportunity and the challenge for 2018 is now we are everywhere, so we need to grow the same-store sales of the delivery business. And on top of that, we are integrating the Pizza Hut Home Service and Pizza Hut Dine-In as well. So the growth rate slightly -- slowed down slightly compared to 2017 from the coverage. And also, you will understand, the industry -- the delivery industry is going through consolidation in China. They are also rationalizing their business models, so you can imagine the subsidies or the promotional support from the third-party aggregator has subdued a little bit. And that's another reason why, for 2018, we are aggressively building our own channel as well because we can see the future benefit of strengthening our own channel sales or our ability to drive traffic from own channel while also building the delivery capabilities, the rider team with Pizza Hut. And the long-term direction is not too different from what we have been doing with KFC in the last few years. So in terms of strategy, Lillian, in Pizza Hut delivery, we are moving towards more the -- building the own channel with stronger percentage of traffic from own channel, building our own delivery team, delivery rider team while we, of course, in parallel are working with the aggregators. So I hope that answer your question, Lillian.

Operator

Your next question comes from the line of Xiaopo Wei from Citigroup.

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

I have 2 questions. First for Joey. Before I look at operation of KFC in second quarter, I'm seeing that accelerated openings and the decelerated same-store sales. But if I look at restaurant margin, the restaurant margin is quite resilient relative to our expectation because, usually, when I'm seeing decelerated same-store sales, there will be deleveraging. We understand -- we would like to understand the reason. Is that because a strong delivery, preorders or better economics of the new openings? And is that the right way to look at system sales looking forward at the KFC business rather than same-store sales? Any color from you are very appreciated. The second question is for Jacky. We are seeing significant drop in the headquarter G&As. Could you elaborate whether this trend will continue in the second half of the year.

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

Thank you, Xiaopo. It's good questions. For KFC, given our size of operation, how many store we have, driving same-store sales is really not easy, but we are committed to it. But at the same time, the China market is still a growing market, still has a lot of opportunity. We still have the long-term growth potential to reach 20,000 store. Therefore, we -- as a management team, we need to maximize the opportunity and the growth opportunity here for our shareholder by capitalizing on both same-store sales and new store opening. And Q2 is a good example that the new store opening actually will put pressure on same store sales things ourselves, but it's absolutely the right thing to do. So internally, we, of course, look at the system sales growth. And actually, historically, back to the high-growth time of Yum China, management really focused a lot on the system sales growth because the new store opening contributes such a high percentage of the sales and profit to the business. But right now -- even right now with our 5,600 store, we still see new store opening as a significant source of contribution. So internally and I hope externally, we have more balanced focus on the system sales growth other than just same-store sales growth. In terms of the margin, I think KFC team, over many years, have become very, very good at managing the margin. While on the one hand, whenever we achieve some cost saving, either from cost of sales, cost of labor or G&A, anywhere, our first priority is to reinvest back to customer, let customer have the benefit. And we believe that's the absolute right thing, right way to build a brand in the longer term. But specifically, if you look at the cost of labor from 2014 onwards, KFC cost of labor is maintained at about 20% plus, slight -- still have not broken the 21%. So we have very strong commitment to maintain -- to manage the cost in order to pass back the savings to the customer. Your question is not about Pizza Hut, but actually, I just want to point out that, that's 1 opportunity for Pizza Hut because, back to 2014, I remember very clearly because that's the year when I joined, both Pizza Hut and KFC cost of labor is 20%. But right now Pizza Hut cost of labor is 25%, touching 26%. Why there's such gap over the years? Because KFC had been using -- have been effectively using the technology in the stores to help manage their labor cost. And that's the area that we believe Pizza Hut will have the opportunity going forward, thus, the investment and the -- in the last 2 years to develop a program like table-side ordering, et cetera, et cetera, because the labor cost will keep going up. It's our management's job to find ways such as through technology to manage that. So I hope I answered your question, Xiaopo. I'll pass it on to Jacky to answer the G&A question.

Jacky Lo - *Yum China Holdings, Inc. - CFO, VP & Treasurer*

Thank you, Joey. Xiaopo, on your second questions on G&A expense, obviously, it is very encouraging to see that our G&A expenses decreased year-over-year in this quarter. I mean, this is the first time we achieved a G&A cost reduction since spinoff. So the quarter and year-to-date decrease in G&A expenses, excluding the impact of foreign exchange, was primarily driven by a mix of one-off benefit and ongoing cost control. I mentioned this on the last call. We set up a special task force in late 2017 just to proactively analyze and manage G&A cost. So we review our overall cost structure, our policies and processes around G&A cost to identify savings opportunities. So in the second quarter, we already started to see some positive effect. And we intend to reinvest some of these G&A savings into new businesses initiatives for the long-term growth of the company. So in the long run, our goal is just for G&A cost to grow at a slower pace than our revenue growth.

Operator

Your next question comes from the line of Brian Bittner from Oppenheimer.

Michael A. Tamas - *Oppenheimer & Co. Inc., Research Division - Associate*

This is Mike Tamas on for Brian. Just a quick follow-up on KFC. I'm still not sure that I totally understand what happened kind of sequentially from the first quarter. I understand the comparisons were tough and whatnot. But it sounds like the softening consumer and the stepped-up competitive environment and the effects of cannibalization are not things that are going to turn overnight. So I just want to see, how do you think about same-store sales over the next several quarters, especially with the tougher comparison for the next 2 quarters.

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

Thank you, Mike. Given our strong seasonality in our business, it's actually very difficult to compare performance on a sequential basis and forecast on a quarterly basis. Q1 KFC, the same-store sales was very, very good. We have 3 very strong Chinese New Year that was historically high 1 year after another year, another year. The team has done a brilliant job to capture that. For Q2, it's on par with our management trend on this very, very low positive side. It's like 0.3%, something like that. The competition certainly has impact, but we have very, very strong program. The new product, which is one of the most important driver of our same-store sales, performed very, very well. And we have very solid program for the Q3 and Q4 as well, and we remain confident with our KFC plan. But in terms of the economy softness, we do see -- I mean, it's nothing sort of solid number, et cetera, but you kind of just have to feel that it has certain psychological expectation because we can see our competitors are putting up very, very aggressive promotional activities to either meet the expectation, the customer want more value right now or in the anticipation that there's certain softness in economy that we need to respond to or prepare for. But we remain confident with our program because there are many factors we cannot control. What we can control is our new product, our capability marketing and our ability in the 460,000 staff and in KFC's case, 360,000 staff's ability to execute the program very, very well. Thank you, Mike.

Operator

Your next question comes from the line of Anne Ling from Deutsche Bank.

Anne Ling - *Deutsche Bank AG, Research Division - Regional Sector Head of Asia Consumer and Media Research*

A question on the -- also on the KFC. We talk about like accelerated store opening trend. But in fact, right now I would have thought that the rental cost will move up a bit because we have some like new store. But it was actually controlled, but however, it seems that there is a like cost of goods sold. The food cost actually increased. So how should we look at like, moving forward? Is it because we are -- the reason is we are doing a little bit more promotion that actually hindered the second quarter like the margin rather than store opening time we're investing in the new store? And in third quarter, we noticed that we are seeing some promotion regarding return -- some of the promotion returning to the price back in like 30 years ago. So does it mean that we will see a weaker GP margin in the third quarter? And second one is on the delivery side. We also see that delivery side, I'm seeing some slowdown for KFC. From -- in the past, like 40%, 50%; so these days, about 30%. So do we think that, moving forward, this will be the new sort of norm? Or we will see some pickup in the future? And do we have any breakdown in terms of how much of the sales these days in the online delivery come out from our own apps both for Pizza Hut and also KFC?

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

Maybe Jacky can handle the cost side, and then I'll talk about the promotion price back to 1987. Okay?

Jacky Lo - *Yum China Holdings, Inc. - CFO, VP & Treasurer*

Yes. Anne, in the short term, our strategy for KFC is just to proactively invest in food upgrade and value for money to drive top line growth. I mean, the competitive environment's increasing. It's getting more intense. And also, KFC, we are focusing on accelerating new builds to capture market share and build the brand. So this helps to drive system sales growth and operating profit growth, but albeit it creates some short-term pressure on same-store sales and margins. But same-store sales and margins, obviously very important for us for KFC, but the brand is in a market growth phase. China is still expanding rapidly, so store -- new store expansion is the key strategy for KFC. So in the long run, it's our market share gains and also our scale expense. And with the investment in digital, data and all the other technologies, efficiencies will improve, so it will create some opportunities for margin expansion and also same-store sales growth.

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

For the food cost, I just want to comment on our thinking to build a brand. Like, you will see we have some quite exciting ingredients sometimes like the crayfish and -- et cetera, et cetera. What KFC has been doing quite well is whenever we could, whenever we could, we will have some -- we will invest in some very nice ingredients to say thank you to our customer. Usually, when we do such -- when we put together such ingredient, product, the margin's slightly higher. But from our point of view, it's okay because it usually drives the ticket average a little bit more at the cost of slightly tighter margin. So in the short term, we benefit from ticket average. In the long term, we build the brand because you want your customer to think that you have -- we have fantastic food and fantastic product. And actually, our approach is, you know, to a certain extent, is becoming a case study in our industry, if not, in other -- in the retail industry in China. Let me focus on the delivery sales. Delivery right now I mean, the percentage seems to -- sort of on the service slowed down because it grew 26% year-on-year and right now contributed 16% of our sales in Q2 but partly because the pie, the base gets bigger now. The base is much bigger now. For Pizza Hut, it's already 24% of our sales. So when the base gets bigger, the growth rate would naturally slow down. And also, we can see -- as I mentioned earlier, we can see the third-party aggregators. They are going through consolidation in their industry to rationalize the business model. So we have seen sort of the subsidies or the promotional activities have slowed down from the aggregator. So in a way -- in a short term, sort of will put some pressure on our sales, but I think, in the long term, this will come. We expect it. And it's the right thing to do because the market bit by bit is back to normal instead of being funded or pushed up by some excessive subsidies in the market. So Anne, I hope that answer your question.

Anne Ling - *Deutsche Bank AG, Research Division - Regional Sector Head of Asia Consumer and Media Research*

Yes. And how fast are we...

Millicent Tu

Sorry, Anne, I think -- sorry, Anne, we have a lot of people in the queue. Can we just move on? And you can jump back on to the queue later on.

Operator

(Operator Instructions) And your next question comes from the line of Sara Senatore from Bernstein.

Sara Harkavy Senatore - *Sanford C. Bernstein & Co., LLC., Research Division - Senior Research Analyst*

So I am just trying to understand what exactly the cannibalization impact might be from new units on same-store sales because you've mentioned it a couple of times. And I was hoping you could quantify what you think that is. And then is there any offset from the fact that stores tend to have better same-store sales in the first couple of years after they're open as they sort of ramp to mature volumes? So if that's the case, if you could just give me a sense of the maturity curve because there have been periods where KFC has grown faster in terms of units, but historically, it's had positive same-store sales at the same time.

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

Sara, I think there are a few parts of the question here. For the cannibalization, well, when we open a new store, let's say you -- let's take an example, if we -- in a small city, we have 2 KFC stores. We opened a third one. well, you would -- you can see the sales -- we'll have certain sales transfer from the old store to the new store. So the old store would have some impact on the same-store sales, but net-net, it's the right thing to do because, in a market, we have higher system sales growth if that makes sense. Historically, you get -- we get both because the base is different. If the base is smaller, then the impact on the existing store is slightly less. Now we have stores everywhere, especially in top tier cities. So the base is different. And thus, when we have the new store opening, it will have slightly stronger impact on the existing store. Maybe Jacky can [add to that].

Jacky Lo - *Yum China Holdings, Inc. - CFO, VP & Treasurer*

I'll just add on to what Joey said. Well, yes, cannibalization is really difficult to quantify because, I mean, you also have competitors adding new stores as well. So overall, it's just a mix of competition and also our own rapid expansion. And on your questions on maturity curve, maybe I can just share with you. Approximately, it takes 3 to 5 years to reach sales maturity. It depends on location. So it's location by location. But historically, China has been growing so fast, so you see both same-store sales and also store expansion at the same time.

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

Maybe I'll just add one comment. Like in particularly in lower tier city, why do we still insist on opening new store even the situation we see the impact on the existing store? Because, historically, we also learn that if we open up stores deeper and faster, we will have the first-mover advantage to grow the taste of customer, and that is invaluable to us because once customer like our taste, they are KFC customer in the long, long time. So that is more from the marketing point of view, but we have learned that lesson over 30 years.

Operator

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

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

I've got just one question on KFC same-store sales growth in Q2. Just try to get a better sense on what is going on because we have started various reasons at different part of this conference call. I'd like to know, if you look at the traffic decline pressure in Q2, are we seeing more pressure in the lower tier cities or in the bigger cities? And also, the -- in terms of the same-store sales growth, is it more because of the cannibalization from the new store opening? Or it is more because of the more promotional environment, high competition, softening consumption environment in China because a lot of other restaurant names have also reported pretty good numbers in for Q2?

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

Maybe let me just make few comment, and then Jacky can comment on the specifics. For our numbers in Q2, we certainly see the pressure a bit more than historically in the lower tier cities. We have talked about how many store we opened in Q2, for the first half, 65% more. And you can imagine our competitors, big and small, are opening store in lower tier city aggressively as well. So historically, in Yum China, we have higher same-store sales probably generated by the lower tier cities in many occasion, but we certainly see the impact of new store opening in lower tier cities. But at the same time, for the same-store sales, I think you have pointed out very well that we also feel the pressure from the significant increase of the promotional activities from our competitors as well. So that put some pressure on us for sure. I realized I forgot to answer Anne's question earlier, but that's along the theme. So I might just bring it in, is the return the price to 1987 promotion. That is a very interesting promotion because it's very, very deep discount, but we worked out the number. It worked for us. It worked for us in many ways. It drive traffic, but most importantly, it built the brand. We first ran that promotion -- it's not new by the way. We ran the promotion back to last year when we celebrate our 30 years anniversary, and we realized 1 key asset of KFC is the emotional connection between us -- between customer and KFC brand. People from our generation have such strong emotional feeling of 1987 KFC. So we want to capitalize on that, and we want to build the brand in the long term. So in the short term, we've got extra traffic. The numbers worked out. In the longer term, it built the brand. So for us, therefore, we continue to run that, and we probably will continue to run that in the future. But usually, such deep discount program is very short, few days, and that worked really work. And our customer likes it, and we like it too. Jacky, any other comments?

Jacky Lo - *Yum China Holdings, Inc. - CFO, VP & Treasurer*

Yes, in terms of traffic, I'll just add on what Joey just said. I mean, the -- we have seen the industry stepping up promotional activities, and obviously, there's more competition in the lower tier cities. But I think, overall, KFC, we have a very clear strategy set up for long-term growth in market share and profitability. So we are very confident in the sustainability of KFC's leading position in the quick service restaurant industry in China.

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

I guess, one last thing I want to add is KFC has gone through some very interesting time over 30 years, many ups and downs. Back to 2014, we have double-digit negative comp growth for the business, but from there onward, we have gone through very strong turnaround and revitalization. And what has it done to the team is we have amazing team right now that are ready to take on the market challenges and to compete effectively in China and to maintain our leadership here. I sense there is concern of the softness of the economy, and I also acknowledge the increased competition. Actually, [Luo Chen], the competition in China's dining sector, the increase of competition is more significant in casual dining than in QSR. We certainly saw that. So in the QSR competition, the number of new store that came into the market last year, it was sort of just on par with what we expected. And KFC is in very good position to maintain our leadership. However, on the casual dining sector, the increase of the number of stores, both from existing and from the new competitor, is very significant. The increase is very, very significant. However, we also -- that was 2017 by the way. 2017, we saw significant increase of new store coming in. But in 2018, China, ups and down, we already see the exit or the closing down of many stores as well. But I guess, the beauty for KFC and Pizza Hut as well, we've been here for 30 years, and we have successfully compete and survived and established the leadership in our position -- in our market position, and we have confidence that we can continue to do that as well.

Operator

Our last question comes from the line of Matt McGinley from Evercore ISI.

Matthew Robert McGinley - *Evercore ISI Institutional Equities, Research Division - Restaurant Analyst*

Jacky, I have a quick follow-up on the G&A. And I understand that you have that special task force that you said would manage that given the high growth rates from the prior year. But I'm just not sure I understand how much of that step-down either sequentially or year-over-year with the structural reduction in your G&A base versus onetime events like not [take] stock-based comps. So can you, I guess, help me understand what the underlying base is of the G&A compared to what we saw, I guess, in first quarter or even year-over-year?

Jacky Lo - *Yum China Holdings, Inc. - CFO, VP & Treasurer*

Okay. Well, Matt, so as I mentioned, the G&A decline, it was a mix of one-off benefits and ongoing cost control. So just for Q2, we were actually helped by some government subsidies, which is one-off, and then we have also performance-based compensation as the decrease. But overall, it's offset by the salary increase or annual merit increase. So that's the high level breakdown of the G&A decline. Yes -- but again, our long term -- in the long run, our goal is just to keep G&A growth less than our revenue growth.

Millicent Tu

Okay. Thank you, Jacky. And thank, everyone, for your time in joining the call. With that, we conclude this earnings call. Have a good day. Thank you.

Operator

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