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YUMC - Q3 2017 Yum China Holdings Inc Earnings Call

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OCTOBER 06, 2017 / 12:00AM, YUMC - Q3 2017 Yum China Holdings Inc Earnings Call

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## PRESENTATION

### Operator

Ladies and gentlemen, thank you for standing by, and welcome to the Yum China 2017 Third Quarter Earnings Conference Call. (Operator Instructions) I must advise you that this conference is being recorded today, Friday, the 6th of October 2017. I'd now like to hand the conference over to your first speaker today, Ms. Christie Ju, Vice President of Finance, Head of Investor Relations at Yum China. Thank you. Please go ahead.

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

Thank you, Kevin. Good morning, and good evening, everyone. Welcome to Yum China Q3 2017 Earnings Call. Please note, a PowerPoint presentation and a live broadcast of this call are available through our IR website under the Events and Presentations section.

Joining me today are our CEO, Micky Pant; President and COO, Joey Wat. As you have seen in our announcement today, Joey will become our new CEO effective March 2018. We also have CFO, Jacky Lo, on the call. And we will start with opening remarks from Micky, Joey and Jacky, and then open the floor for Q&A.

Please note our earnings call and Investor Presentation contain forward-looking statements, which are subject to future events and uncertainties. Our actual results may differ materially from these forward-looking statements. And all forward-looking statements should be considered in conjunction with the cautionary statement in our earnings release and the risk factors included in our filings with the SEC.

Let's start on our agenda page, on Page 3. Micky will start with our Q3 highlights. Joey will discuss brand performance, and Jacky will review our financial results. After opening remarks, we will be happy to take questions from analysts and investors.

Now let me turn the call over to Mr. Micky Pant.



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**Muktesh Pant** - *Yum China Holdings, Inc. - CEO & Director*

Thank you. Thank you, Christie. And let me add my welcome to all of you from the headquarters at Yum China here in Shanghai. As you probably saw earlier today, we made 2 announcements: the first concerns our third quarter results; and the second was an announcement of Yum China's CEO succession plan. I'm very pleased that we and the Board of Directors of Yum China, have agreed that Joey Wat will be the next CEO of Yum China with effect from March 1, 2018. You've all witnessed Joey's leadership skills and successful track record, and I'm thrilled to hand over the reins to such a great leader in a few months' time.

At the same time, I was honored and delighted to be asked by the Board of Directors to stay on the board as Vice Chairman and to serve as an adviser. I love this company, the brand and the China team, and I'm confident that this transition plan will be very smooth. I'd be happy to answer questions on the succession when come to the end of the call, but the primary purpose of today's call is to describe our third quarter results. So without further ado, if I can direct your attention to Slide #4, if you have access to our presentation.

Our third quarter results illustrate strong performance at Yum China with overall same-store sales up plus 6% and system sales up plus 10% before ForEx. KFC delivered an impressive plus 7% same-store sales, and Pizza Hut same-store sales stayed even with last year. Operating profit grew 11% to \$317 million. We reported a basic EPS of \$0.55, which is up 4% year-on-year. And on a fully diluted basis, our EPS was \$0.53, which is flat with a year ago. Our adjusted EBITDA reached \$425 million for the quarter, and cash and short-term investments stood at \$1.6 billion at the end of the quarter.

You'll get a lot more details from Jacky but I, in particular, request you pay attention to 2 aspects, and those are his comments related to diluted share count and the effective tax rate, both of which impacted our diluted EPS.

Moving on to development. We opened 129 new restaurants, and we remodeled 200 stores led by KFC. At the end of the quarter, we stood at 7,747 restaurants in our system.

We continue to make strong progress in digital and delivery, and with over 5,100 restaurants offering delivery, that's 5,100 restaurants offering delivery, our total delivery sales in the quarter reached \$287 million, so about 14% of our company's sales. Mobile payment represented 45% of our company sales. And cashless payment reached a record of \$1.2 billion in Q3, which was more than 60% of our company's sales. I believe China is the leader in the world in cashless sales, and our company is one of the leaders in China.

Our loyalty members for 2 brands surpassed 120 million in total, with 97 million and 30 million members for KFC and Pizza Hut, respectively, and Joey will share more details of this later.

Finally, our Board of Directors approved a regular quarterly cash dividend and declared an initial dividend of \$0.10 per share for the quarter. In addition, the board increased our share repurchase program to \$550 million from the \$350 million previously. In the first 3 quarters, we have so far bought -- or to the end of the third quarter, bought 3.4 million shares with an aggregate spending of \$128 million.

If you can move to Slide #5 now, you can take a look at our same-store sales and system sales performance for the last 7 quarters. The chart on the left shows same-store sales for our restaurants. You can see the trend is encouraging. In Q1, we lapped a very strong Chinese New Year of year ago with plus 1. In Q2, we lapped a flat performance of plus 3. In Q3, our same-store sales improved by plus 6%. The chart on the right shows the corresponding number for system sales, and in Q3, our system sales, as I mentioned, grew 10% year-on-year, so the overall trend is in the right direction.

Let's move to Slide #6. Our restaurant margin continued to improve on the back of solid same-store sales, and restaurant margin reached 20% in Q3. And our operating profit increased 11% to \$317 million. You can get more financial details from Jacky Lo later.

Slide #7 is important. We've recently conducted a strategic review with our Board of Directors, and I would like to share with you 4 key strategic priorities for our business to shape our strategies.



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The first is to focus on China. With 30 years of operations and a deep understanding of Chinese consumers, we are well positioned to benefit from the strong consumption growth in China and will continue to invest for growth in China.

The second is to strengthen our core business in KFC and Pizza Hut for store image improvement, menu innovations and improving the quality of our food and services.

The third is to leverage our leading position in digital and delivery to drive growth. We strive to maintain our leadership position through a continued investment.

And last but not least, to drive future growth through innovation, such as new product categories, formats and day parts, and you will see some examples later.

We continue to be optimistic about prospects for long-term growth in China. And as you know, Joey Wat leads both KFC and Pizza Hut brands, so I will now hand you over to Joey to go over the performance of our brands. So with that, Joey, over to you.

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

Thank you, Mickey. Greetings, everyone. Now let me summarize the performance of KFC and Pizza Hut in the third quarter of 2017, starting with KFC on Slide 9. It highlights the key performance of KFC in the quarter. KFC delivered plus 7% in the same-store sales and system sales grew double digit at 11% because we have a rather low base last year. In this quarter, we built 81 new stores, and we remodeled 173 units. Year-to-date, we have built 215 stores and remodeled 378 units in total. Our financial performance was also strong, both restaurant margins and operating profits continue to improve. Jacky will cover the numbers in more details.

Slide #10, let's take a closer look at same-store sales and system sales. We see strong growth in same-store sales and system sales. Lapping a low base last year, we delivered 7% same-store sales year-on-year in Q3, driven by 3% growth in transaction and 4% growth in ticket average. System sales growth reached double-digit, 11%, thanks to strong same store sales and new store openings at the same time.

Let's move to Slide 11. In the third quarter, KFC launched a series of innovative products. CHIZZA, a combination of chicken and pizza, was a disruptive product with unique features in flavor and in presentation. It creates good social buzz and drove transaction into our stores. Summer holiday is one of the most important times of the year for our younger customers. We launched Angry Burger with -- and we worked with TFBoys, a highly popular boy band among teenagers, to promote this particular product. The campaign resonates very well with young customers, and we saw a strong response in social media and good feedback on its unique appearance and good taste. Another example is our innovative rice roll, a new signature product for breakfast. It showcased our strong capability to create localized products that Chinese consumers enjoy. The successful launch of rice roll helped to drive business in breakfast and build a customer base for this very important day part. In the past 30 years, our popular kid's meals served a few generations of Chinese customer as well. For Children's Day this year, KFC worked with a pop culture icon, Transformer, with strong response.

Slide 12. Going digital is an essential step to engage with our customers and improve CRM. Here, we showcased a few examples of how KFC is enhancing the digital experience for our customers. Our 97 million KFC loyalty members are playing a more and more important role in driving our business. They are the focus of our marketing campaign. A good example is the launch of CHIZZA. We offered a member-only privilege 3 days before the official launch. The campaign successfully created an online buzz. It helped build up the momentum for the first day of its official launch. K-Gold is another reward to our members from purchase. In our K-Mall, members can redeem product or play a lucky draw using K-Gold.

On Slide 13, delivery has become increasingly important for Chinese restaurant industry and to our company. We are driving delivery business through network expansion, digital innovation and marketing campaigns. In this quarter, delivery represents 11% of our company's sales. In July, we expand our delivery business through select stations of China's high-speed rail network, the largest in the world. Customers can preorder our food before their journey and get KFC food delivered to their seats. With high-speed rail delivery has just started, we are confident about its growth potential in the future as well. Digital play a more and more important role in our delivery business. We leverage our digital platform to promote members-only offerings such as WOW bucket. We believe our digital and delivery capabilities provide a strong foundation for digital growth.



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Slide 14 shows some photos of our newly launched KPRO, a concept that appeals to China's urban professionals. KPRO offers a creative, modern and seasonal menu, including make-to-order salad, panini and roast chicken. KPRO also integrates Alipay's new Smile to Pay facial recognition payment solution and other technical innovations. The facial recognition payment is the first commercial application of this technology from Alipay which enables customer to pay without reaching for their wallets or mobile phones. Our first KPRO pilot store was opened in Hangzhou in July featuring a greenhouse layout and design and an open kitchen, creating a friendly and vibrant food market atmosphere. For those of you who are coming to our Investor Day, you'll be able to try it for yourself. We are learning valuable experiences to serve young and test every customers who are keen to embrace new taste and innovation.

Move to Slide 15, let's review the performance of Pizza Hut in the quarter. In the third quarter, same-store sales were flat from last year while system sales increased 7% on a constant-currency basis. We built 38 new restaurants and remodeled 27 stores. Pizza Hut reported \$80 million operating profit with restaurant margin over 17.8%. Jacky will cover the numbers in more detail.

Let's take a look at the same-store sales growth and system sales on Slide 16. Lapping a 4% decline in Q3 last year, Pizza Hut same-store sales were flat in Q3 with a 3% transaction increase and a negative 3% in ticket average, mainly driven by increase in delivery business. While the positive transaction growth at Pizza Hut is encouraging, there's still a lot of work ahead of us. On the other hand, our system sales maintained healthy growth of 7% year-on-year.

Slide 17, I would like to point out some initial progress we have made to revitalize Pizza Hut. First, on store fundamentals, our menu demonstrate effort we have taken on food innovation. We will continue to work on menu rationalization and revamp customer service to improve buying experience. We are making significant investments in raw materials and ingredients to improve the product quality and taste. And we believe this is the right thing to do. Jacky will cover the financial impact of this later.

Second, we are in the process of consolidating the delivery network under Pizza Hut. Last but not least, we are trying a few different store formats, including bistro model, to target different customer segments. We are investing in many areas of our Pizza Hut business. Let me provide more details in the subsequent slides.

Move to Slide 18. In August, we launched a series of new products for summer holiday. Our crayfish pizza has good taste with good value for money. The appetizer platter offers a variety of select products and help drive the ticket average. We also upsized our drinks by 30% across-the-board without increasing price, which effectively stimulated the category sales. Going forward, we will continue to invest in our product improvements.

The final exam week is also very important for students in China. At the same time, the Chinese name of Pizza Hut, (foreign language), means "must win" in Chinese. We offer a 20% off discount to students with a free good luck sticker. This campaign was also very well received by students and their parents.

Slide 19, a quick review on our digital efforts. In July, we launched Pizza Hut Super-App integrating Pizza Hut's delivery business into one platform. The new app provides convenience and efficiency to our customers and helps us to better understand customer needs. Similar to KFC, Pizza Hut members can also receive K-Gold rewards. It generated over 3 million downloads in 2 months. In addition, our Super-App also provides exclusive offers for members such as the Monday member's day program. This type of event was well participated and effectively drove traffic. Pizza Hut accumulated 30 million loyalty members by end of August, and mobile payment accounted for 35% of its sales.

Slide 20. Delivery contributed 21% of Pizza Hut sales in Q3 with over 2,000 stores offering delivery services by end of the quarter. We are in the process of consolidating the delivery platform under the Pizza Hut brand. We leverage our own platform as well as all major third-party aggregators to generate delivery orders. The orders are delivered by our own riders and third-party riders as well. Going forward, we will optimize our delivery network to provide high-quality food and speedy service to our customers. We see delivery as a strong growth engine to drive future growth.

Slide 21. We continue to test different store formats, including Pizza Hut bistro, a smaller-sized fast casual concept offering great food and efficient service. Pizza Hut bistro adopt an open concept to create a bright and contemporary image with a simplified menu. Pizza Hut bistro offers open counter for salads and drinks, and main dishes will be served at the table. This service model could reduce waiting time while improving labor



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efficiency. In addition to bistro, we are also experimenting with other store formats. While it would take time to turn around the Pizza Hut brand, we have made some solid progress.

That concludes my remarks. Let me turn it over to Jacky, CFO of Yum China. Jacky?

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

Thank you, Joey. Good morning to those calling from Asia, and good evening to those calling from the U.S. As you have heard just now, we are encouraged by the strength of KFC. Under Joey's leadership, KFC achieved strong business and financial performance and continue to build on this positive momentum. At Pizza Hut, we have a clear plan to revitalize the brand. We are experimenting with a number of initiatives which may not lead to sales impact immediately, but we believe they are necessary for the long-term health of Pizza Hut.

Now let me start with an overview of our third quarter results, and then give you an update on our capital allocation strategy. Let's take a look at our third quarter results on Slide 23. Our system sales grew 10% excluding the impact of foreign exchange. This was led by our strong same-store sales growth of plus 6%. During the third quarter, we opened 129 new restaurants. Additionally, to enhance our brand image and customer experience, we remodeled 200 units. Execution of our robust development plan continue to contribute to our sales growth. Our restaurant margins reached 20% during the quarter, up 0.8 percentage points year-on-year. I will elaborate on the drivers for restaurant margin expansion in the subsequent slides. I'm pleased to report that we delivered a solid profit growth in the third quarter. On the back of healthy revenue growth and margin expansion, our operating profit increased 13% year-on-year, and our adjusted EBITDA increased 11% year-on-year, both excluding the impact of foreign exchange.

Moving on to Slide 24 for our restaurant margin and operating profit. Let's take a look at KFC first. KFC had a strong third quarter. We continue to build on the healthy momentum from the first half of this year and leverage on our digital and delivery platforms, social media marketing and disruptive food innovations between new concepts. We are pleased that restaurant margin increased 1.4 percentage points, and operating profit increased 22% year-on-year, excluding the impact of foreign exchange. The increase was primarily driven by same-store sales leverage and partially offset by wage inflation and promotion cost. As we enter into the fourth quarter, we'll continue to invest in our product, which we think is the right thing to do for our brand.

Turning to Slide 25, let's take a look at Pizza Hut. During the third quarter, Pizza Hut's restaurant margin declined by 0.9 percentage points year-on-year, mainly due to promotion cost and high labor costs, partially offset by labor efficiency.

Now I would like to give you further colors on what we are planning to do in Q4 and how that may impact restaurant margins. As you have heard from Joey earlier, we plan to fix the fundamentals for Pizza Hut. We will continue to invest in product and service upgrades in the next quarter. We are also assessing the risk of store impairment as part of our Pizza Hut integration project. And at the same time, we continue to face wage inflation. So all these factors may impact Pizza Hut's restaurant margin and operating profit.

Last but not the least, I would like to remind you that our sales, operating profit and margins are subject to seasonality. We typically experience lower profit in the fourth quarter. This is true not only for Pizza Hut but also for KFC.

Let's go to Slide 26. There are several factors that impacted our third quarter financial results. Let me touch on the first 2 factors, which are the effective tax rate and diluted share count. In the third quarter, our effective tax rate was 31.7% as compared to 29.8% in the third quarter of last year. This was due to higher cost of repatriating current year earnings into the U.S. Diluted share count increased by 9% year-on-year due to the new shares issued to strategic investors upon spin-off on November 1 last year, and the dilution impact of previously granted share base awards and warrants. The combination of high effective tax rate and diluted share count led to a flat diluted EPS year-on-year. So if you look at our net income, it was actually up 11% year-on-year, excluding the impact of foreign exchange. And for the full year, we expect our effective tax rate to be no more than 30%.

The third factor that impacted our Q3 result is G&A cost. It was up 21% year-on-year, excluding the impact of foreign exchange. The increase was a result of high compensation cost, partially attributable to hiring additional personnel and higher professional fees as a result of being a public



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company. For the full year 2017, we now expect G&A growth of low teens percentage in local currency. But having said that, we'll continue to look for ways to optimize our G&A cost structure.

Next is restaurant level inflations. Our wage inflation was 7% and commodity [inflation was] 1% during the third quarter. As for commodity inflation, we are comfortable with our guidance of low single-digit inflation for the full year, as we expect commodity inflation to remain fairly subdued in Q4. And to sustain restaurant margins for all our brands, we'll continue to grow our same-store sales growth to offset the impact of restaurant level inflations. Finally is currency translation, which negatively impacted our operating profit by \$5 million in the third quarter.

Now let's move to Slide 27, which highlights a powerful aspect of Yum China's business model, which is our ability to generate substantial free cash flow. Year-to-date, we generated free cash flow of \$725 million. Our balance sheet remains strong with about \$1.6 billion in cash and short-term investments. We'll continue to utilize cash to reinvest into our core business, enhance our strategic decision and create value for shareholders.

Now let's turn to Slide 28. We have reviewed all of the capital allocation options with our Board of Directors, and we like to report to you as follows: First, we are confident in our ability to generate free cash flow, so we are initiating a quarterly dividend at \$0.10 per share with room for higher pay out in the future subject to Yum China's capital needs. In addition, our board has approved a further \$250 million for share repurchase. That brings our total share repurchase authorization to \$550 million. By the end of August, we have repurchased approximately 3.4 million shares totaling \$128 million.

Finally, we believe China remains an extremely attractive market for capital investment. As a result, we'll continue to implement strategic initiatives to enhance our capabilities and also look for growth opportunities that leverage the unique strength of Yum China. In less than a year since we have become an independent public company, we have successfully initiated on all 3 aspects of our capital allocation strategy. So this wraps up my remarks, and I'll now turn it back to Micky.

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### **Muktesh Pant** - Yum China Holdings, Inc. - CEO & Director

Thank you, Jacky. So before we open up for Q&A, we are right on time at about 30 minutes. Let me summarize the quarter, Q3, on Slide #29. We delivered a strong performance in the third quarter and there are 3 statistics of particular significance: The first was 7% same-store sales growth for KFC; the second, that our loyalty membership program increased to over 120 million members from the 100 million last quarter; and lastly, we collected over USD 1.2 billion of our sales through noncash in the last quarter alone. So based on the performance of the first 3 quarters, we are confident that we will be able to deliver our 550 to 600 new units, coupled with a double-digit operating profit growth, ex foreign exchange, for the full year.

As mentioned before, Yum China will host our 2017 Investor Day on October 17 through 19 in China, in Shanghai. And for those of you registered for the event, we look forward to seeing you in Shanghai. So with that, I'll turn you over to Christie who will commence our Q&A.

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

Thank you, Micky. And we will now open the floor for Q&A. (Operator Instructions) Operator, we can now start the Q&A.

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## QUESTIONS AND ANSWERS

### **Operator**

(Operator Instructions) And our first question queued comes from John Glass from Morgan Stanley.



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**John Stephenson Glass** - Morgan Stanley - MD

Jacky and Micky, a couple of times you mentioned investments needed in the business, and I guess particularly Pizza Hut. Can you talk, one, about sort of dimension in terms of the size of those investments, either margin impact or dollars? And was that a comment specifically about the fourth quarter or was that sort of an ongoing comment that 2018 needs to be an investment year for that brand as well?

**Muktesh Pant** - Yum China Holdings, Inc. - CEO & Director

Thank you, John, a great question. I think as you saw, we feel quite confident about KFC and the trends are all in the right direction. And if you recall 2 years ago, the situation was very different. A lot of credit to Joey and the teams for getting the turnaround done. But it did take a couple of years before we were able to see real returns on KFC that included substantial investment in store refurbishments as well as in innovation. And technologies in the store, staffing, the methods by which we remunerate people across the board, across labor control, et cetera, I think, on process and Pizza Hut has started, there's no doubt about that. I'm very encouraged by the bolder level of experimentation. I think one of the many reasons Joey has this new role is that she's a bold leader and makes quick moves. However, it's true to say that at the moment, we are not able to conclude that the experiments and trials that are being done with any accuracy or when they will have an impact. So I would not like to limit our investments to the next quarter. It could run into next year as well. We'll keep you posted. I think the overall thing to remember of course is that Pizza Hut is about 20% or 25% of our overall operating profit delivery. So the big one is KFC. And if you can keep that going, we can -- that's our major focus. However, it is true that Pizza Hut -- and I'm delighted with the change that Joey is leading. That includes, for example, example she mentioned of increasing the size of products without charging more, investing more into cost of goods for a better quality pizza, whether it's cheese or paste -- tomato sauce or whatever it is. So the moves are all good. But they will have an impact. So overall, we're not guiding to any kind of quarterly impact of these. John, it's a little difficult, especially as we are only 1 month to go full-month quarter. The fourth quarter is not a very significant quarter overall in terms of profit delivery, but these investments will have an impact. In terms of overall CapEx, the number is not that significant. I think the one reference Joey did make was that we are trying to consolidate our Pizza Hut delivery and dine in systems into one delivery system. That might have an impact on some impairments as we rationalize it, review it all. But John, we'll keep you posted on it. But at this time, we are not able to give more specifics. Joey, you want to...

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

John, let me try to just give you the item of the investment which we've seen are the right things to do both in the short term, medium term and long term. Immediately, I think customer can see our investment in food and drinks, both in terms of portion and ingredients. We are in food business. This is nonnegotiable. We have to try our very best to provide the best food for our customer. Otherwise, other -- better proposition just won't be strong enough, so that's #1 priority. And then, Micky has mentioned earlier, the store -- the store format, the store upgrades. Pizza Hut overall is quite new. However, it's the design aspect to bring the freshness and relevance to the customer. Third area is digital. As you can see, we launched the Pizza Hut Super-App as early as July. That was very fast. And then we're going to launch the new version again in November. And we know how important this area, and we'll continue to push ahead. At the same time, the CRM. Right now, with 30 million members, we are investing into the marketing for our members. The other area is delivery. We know how important this particular business is to us, and the growth rate is very encouraging. However, for Pizza Hut delivery, unlike KFC delivery, the percentage of food delivered by ourselves is not high enough. We could do more. And I think these are all the areas that we should invest, not only next quarter but next year as well which are -- we believe are all the right things to do at this point.

**Muktesh Pant** - Yum China Holdings, Inc. - CEO & Director

Do you have a follow-up, John?

**John Stephenson Glass** - Morgan Stanley - MD

Just a very brief one. Did you take pricing at either brand this quarter? I know you talked about when the VAT sort of lapped, there may be an opportunity to look back at pricing. Did that happen this quarter? And by how much?



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**Muktesh Pant** - *Yum China Holdings, Inc. - CEO & Director*

Yes. I think we've mentioned -- there's a couple appoints, John. There's about 2% net impact of pricing on both KFC and Pizza Hut, so it was quite modest actually. So 2% on each of the brands, yes, for the quarter.

**Operator**

And the next question comes from Xiaopo Wei from Citigroup.

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

The first question about competition. Could management give us some color on the competition, especially there was a major shareholding structure change in one of our Western QSR competitor in China? And we've heard from the news that there were some aggressive opening plan. What's management comment on that? And what's our strategy? The #2 question about the dividend. We are glad to see the first dividend announced but we know that it's subject to quarterly review. Could management give us color whether it's in the commitment in the ratio -- the P&L ratio or there's a dollar term, a commitment for a minimum?

**Muktesh Pant** - *Yum China Holdings, Inc. - CEO & Director*

Well, I think the best for -- on this is to -- Xiaopo, your 2 questions to be answered by Joey and Jacky, respectively, on competition. I will mention one thing however as Joey starts to respond especially to our principal Western QSR competitor is that, if anything it will take time. And we have a very substantial lead in terms of our penetration as well as the number of stores. But we obviously respect them a great deal and watch them very carefully. So Joey, would you like to give any comments on this competitive activity?

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

Yes, first of all, KFC and our other very well-respected competitor, we've been competitors in China for 20-some years already, so it's not something that's new. For KFC, I think it's very important for the management team to focus of our core strategies. We have learned a lot, and we have made our strategy more and more clear in the last few years. Our focus on our core products, our focus on innovation, our focus on digital and our focus on disciplined store growth. So all these are the right things to do and will stay on up. Of course, we will continue to learn from our competitors, big and small, because that's what we should do in order to stay ahead of the game.

**Muktesh Pant** - *Yum China Holdings, Inc. - CEO & Director*

Thank you on the dividend, Jacky.

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

Yes. On the dividend questions. Given we are a relatively new company, we feel that \$0.10 per share dividend is appropriate. And based on our latest share price, that's equivalent to a 1% dividend yield. This is what the board authorizes to do as well. But well, with that said, we are starting at \$0.10 dividend per share, but our goal is to gradually increase this amount on a per share basis in the future. But of course, subject to our cash needs



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**Operator**

And the next question comes from Brian Bittner from Oppenheim & Co.

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

I got 2 questions. First, when you spun off last year, you talked about targeting an EPS algorithm over the long term of the mid-teens. And there's been a lot of moving pieces. But overall, you've done well against that target. And now, as the model has less abnormal moving pieces going forward with the share count and whatnot, I was wondering if you could talk to your confidence in that algorithm still. Is it still as confident going forward as it was when you spun off? And if not, why?

**Muktesh Pant** - *Yum China Holdings, Inc. - CEO & Director*

Brian, this is Micky. Let me take a shot at it because we discuss this a great deal in the company. If you've noticed over the last 2 or 3 quarters since we became a public company, in all our pronouncements, we've been encouraging our investors to look at operating profit growth, which is where we have a greater degree of confidence. And we've been guiding a long-term confidence that we will grow our operating profit double digits. Though year-on-year, that is never predictable. It could always have a year where that is not [holding]. But in the long term, we expect double-digit operating profit growth. The reason we said that was earnings per share are obviously subject to factors like taxation as well as the share count itself. And if you look at our share count today compared to where it was a year ago, I guess, Jacky, we are approximately 10% higher in terms of number of shares. Now a part of it is on account of the fact that we did issue shares to our cornerstone investor, Primavera. Part of it is because, as you know, Primavera has warrants which enable them to buy when our market value hits \$12 billion and \$15 billion. And the quarter did deliver \$12 billion market value, in fact, currently, it's trading more like \$15 billion. Those have not yet kicked in. But those projects, we cannot really predict when this would happen and when this would get exercised. We use very conservative policies with regard to estimating our total share count, so we do absolutely the right thing in terms of accounting policy. And the share price value itself has an impact on dilution because stock options and other rights held by some of Yum employees, for example, get charged to share count depending on price of the share. So we would encourage you in the first couple of years to -- I think all of us need to learn exactly what's going to happen with regard to share count. But our overall operating profit, we feel confident in the long-term algorithm of double digits. Now we've had exceptional couple of years. Yes, if you look at the last year and this year, I think our operating profit has been substantial, very, very much higher than just double digits. So there might be an off year here and there, but overall, we feel confident that we can deliver that. Sorry, you had a follow-up.

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

Yes. No, that's fair. Double-digit operating profit growth is similarly fair. And then just the second question is you do have over \$1.5 billion in cash. So even after your capital allocation for dividends and share repurchase, you still have so much cash, so much dry powder. And I know you talked about opportunities to invest in China, but it also doesn't seem like there's something that that's large that you could do in China. So I'd just love your thoughts on holding onto all that cash and what you could potentially do with it.

**Muktesh Pant** - *Yum China Holdings, Inc. - CEO & Director*

Yes. Well, look, we don't like to hold onto cash, okay? We are very acutely aware of the interest rates, and we would love to deploy the cash for growth. We are very focused on that. There are certain aspects of our thinking and planning that we cannot disclose because it will compromise our competitive position. We'd much rather execute and then inform at the appropriate time. So we're considering a range of options by which we could deploy this cash for greater growth. And that's part of the reason why we are in the situation that we are in. We did feel comfortable, after a considerable debate, that even though it's less than 1 year since we spun off, Brian, that we would institute a dividend. We feel so confident about our cash flow and our existing cash reserves, we feel that, that will not compromise our ability to grow because the cash flow is extremely rich, and the cash position is very strong. So we instituted the dividend, and the Board of Directors approved the institution of the dividend. They also increased our buyback to \$550 million, which is quite substantial. In 3 quarters, we've spent roughly \$128 million, I think. So we have quite a bit of dry powder to be able to buy our shares back and therefore reduce the share count in the long term. But we are very focused on that. We just



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concluded a 2-day strategic meeting with our Board of Directors. We have an outstanding Board of Directors with a tremendous amount of experience, operating experience in China, a lot of deal-making experience. We have Primavera as a major investor. They have 2 directors in our board. We have a presence from Ant Financial, part of Alibaba, have an observer on our board. So we have a lot of very good guidance in terms of how we might do it. But -- and I said, one of the things we concluded is that we will focus on China rather than look at acquisitions all over the world. We will look at -- we'll focus on China. And we would love to deploy our cash to grow our Chinese business, and we'll keep you posted as that goes on. That will be a big part of our priorities.

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**Operator**

And the next question comes from Christine Peng from UBS.

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

I have 2 questions. The first question is about Pizza Hut. I noticed from Joey's earlier presentation mentioning the new Super-App launched for Pizza Hut. And within that, I noticed you have this K-Gold function on the app. So does that have anything to do with the K-Gold program under KFC? And I think a related question is about -- Joey, do you see any synergy between KFC and Pizza Hut in terms of the membership program, in terms of the delivery capabilities of KFC right now?

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

Christine, the short answer to your question is yes and yes. The K-Gold program is the same as KFC's. So customers can earn the K-Gold in either Pizza Hut or KFC, and they can use their K-Gold to redeem the food or the -- some sort of small things or IP that we produce. The membership program, we do see -- and the delivery, we do see a synergy because we -- obviously, Pizza Hut being a late -- well, being a bit late in launching the membership and the CRM, there's a lot that we can learn from KFC's progress and ongoing practice and technology. At the same time, we can work together such as K-Gold. I mean, it's there. It's done, so we can utilize it. And in terms of delivery, the same. KFC has developed a very good model in terms of working with aggregators but also use our own rider to deliver products. So Pizza Hut, we can learn that from KFC as well. I mean, we do use the riders for Pizza Hut right now, but the ratio is a bit small or smaller than KFC, which we can see the opportunity to increase the ratio. So the short answer to your question is yes and yes.

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

And I think, Joey, you also mentioned the new formats launched for Pizza Hut. Can you provide us more kind of hungry thoughts in terms of how fast this has been happening and what's your plan going into 2018?

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

Sure. There are 2 new formats -- well, we always experiment new formats because we have to move with customers. Customers' needs in China change just so fast. There are 2 formats that we experiment. One is bistro, which I talked about earlier in the brand update session. The other one is called ph+. The ph+, for those ladies and gentlemen who are coming to the Investor Day, if you go to Hangzhou, you would see that particular store within 1-minute walk from the KPRO store. So that is -- the number is very, very small. The number of ph+ store is very small, mainly for the urban professional, tech-savvy, young people, et cetera, et cetera. The bistro, we have plans to open 30 stores this year, by the end of this year, and we are in very good progress to do that. Bistro is a more flexible format. The store footprint, the store size footprint can be a bit more flexible. The menu can be a bit more simplified, and it has small self-service element in it, so the labor cost is a bit more efficient. And so far, we are testing it in different trade zones and different cities. We are encouraged to see the initial progress. But as you will appreciate for new formats, there's always so much to learn because retail is detail for our business. However, for this particular year, we will open 30 of them. And next year is already in the plan, we will open more bistro, which we see as something that will be a very good format to be part of the Pizza Hut business.



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**Operator**

And the next telephone question comes from Matt McGinley from Evercore.

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

My first question is on labor expense. Labor expense as a percentage of sales declined in the quarter despite that 7% inflation. Was the rate of the labor inflation you experienced consistent across both of the brands? And I'm wondering how much of the benefit from a rate standpoint was from a comp growth relative to cost cutting you may have had at either or both brands?

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

Yes. Well, I think for both brands, the labor inflation is about the same. So we expect high single digits for both brands for the full year. But we'll continue to leverage our know-hows, how to manage labor cost. So one example is to improve our scheduling of our staff at the restaurants. So -- but as you can see, at KFC, there are some labor efficiency that helps contribute to our margin improvement this quarter.

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

I just want to add my comment about labor cost as a percentage of sales. In KFC, it has been pretty stable. We managed to control around 20% since 2013, actually, 2013, '14, '15, '16, and probably '17, it will be about 20%. And that has -- that one simple number has so much hard work behind given the size of our labor force and has so much incredibly detailed learning that we should continue to learn. For Pizza Hut, all I can say is there's a lot of work, and there's a lot of learning. And it would take some time for us to learn how to do it properly to control that labor cost as a percentage of sales. We'll talk more when you guys are in Shanghai in 2 weeks' time. I guess one area I would highlight in terms of learning is while we always should push for labor cost efficiency, it's equally important to find ways to take away tasks for our staff. And I say, that would be my #1 learning from KFC, which could be applicable for Pizza Hut. But it takes learning and task and detailed work to get there. But it can be done.

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

Got it. Joey, on the loyalty membership growth. I think a quarter or 2 ago, either you or a member of the team said the focus was on shifting more from getting more members to sign up and focus more on getting more from the existing members. And I assume you don't. You're not going to turn people away that want to join the program. But what are you actually seeing in terms of member spend? Is that -- your membership growth has more than doubled year-over-year in each of the programs. Is that actually driving the comp at this point? Or is it still mainly a medium to just communicate with the members that are your customers?

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

We certainly want both quantity and quality. I mean we have achieved a very substantial membership base, so now we want to drive the quality, the interaction with customer. At the same time, we do see our members right now is contributing a pretty significant sales of -- a significant portion of our sales. Again, I think when it comes to Investor Day, we'll have the specific number for you guys.

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

And Matt, we will be able to provide more color in terms of our loyalty members and their contribution to sales. We will provide more details when it comes to the Investor Day.



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

What I want to say, Matt, is the focus of our team right now -- because there are so many things we're doing. But yet, we still have one very clear focus we want to achieve, it's to drive one more visit from our members. And you'd be amazed how much money that could mean to us -- to our company. So that will be our very clear focus.

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**Operator**

The next question comes from Michelle Cheng from Goldman Sachs.

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

I have 2 questions here. Number one, can you share with us the performance in the different tiers of cities? For the strong max same-store sales growth, particularly for KFC, is there any like tier of cities or areas outperforming? And my second question is about the new store concept, especially for KFC. By looking at KPRO, it looks like the store layout and the product offering are quite different from the traditional KFC store. And at the same time, KFC also have a lot of good product innovation. So are we going to see the new store concept for KFC as well in the future?

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

Okay, Michelle, thank you. For the different tier cities for KFC, also, we are happy with the same-store sales across city tiers. However, with our hard work, Tier 1 cities actually right now are giving us the best sales growth, which is very encouraging. Because Tier 1 cities, as you can appreciate, has the highest level of competition with highest labor cost, with highest rental, et cetera, et cetera. So it's very encouraging to our team that we can do better in Tier 1 cities because if we can survive in Shanghai, Beijing, Guangzhou and Shenzhen, we probably can survive in other parts of China as well. So that is for the city tiers. The other one is the new store concept. You are right to point out KPRO is very different. And I have to say KPRO, we finally have a successful experiment. Actually, we have tried a few times before and finally, it worked. Thank you to the hard work of many, many people in KFC and in Yum China. And we purposely try to have something very, very different because that's how we learn. I mean, we can try sort of the incremental changes in our current stores, like the high-end trade zones, transportation hubs, et cetera, et cetera, but if we want to try something very, very different, why don't we just give it a go? We even changed the color to green from red. That's probably funny enough, as a brand builder, that's a huge decision. So -- and it was one store trial. And we've learned tons, not only in terms of the store layout, the service model, the product, we try even -- something even more aggressive behind the scene. The customer cannot see how do we set up the IT system, how do we try something in terms of our technology. That's critical as well. And we would take whatever learning from there and use it in KFC and in Yum China. So net-net, it's a very, very good experiment, and we are very happy to see positive feedback from our own staff, from our landlord, from our customer. So when you guys come to see our KPRO store, please share your thoughts with us because we are still learning from this particular experiment.

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**Operator**

And the next telephone question comes from Sara Senatore from Bernstein.

**Stephanie Ng**

This is actually Stephanie Ng, representing Sara. A quick question on Pizza Hut. So a flat comp in price implies quite a bit of improvement to your trend. And I know that you discussed a lot of this, it was attributable to the delivery business. But did you observe a change in the dynamics among the delivery aggregators this quarter?



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

For the delivery aggregator, I mean, obviously, we all know that Baidu delivery is part of Ele.me right now, so we are dealing with the key top 3 aggregators, Baidu, Ele.me and Meituan. We haven't seen sort of huge shifts in terms of numbers, but we do see -- what we do see and we do learn is everyone in a market from restaurant operator to aggregators are all trying to improve their service, the quality, the delivery speed. So it's a good thing. We'd like to see that because other than just quantity for our business, which emphasizes a lot on quality, it's good for us.

**Stephanie Ng**

Okay. And a quick follow-up question on the tax rate. As you begin to pay dividends, how should we think about implications on taxes next quarter and the longer term?

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

Well, I think our current tax structure and the effective tax rate are mainly affected by 2 factors. The first factor is the China's corporate tax rate, which is 25% for us. And then the second factor is the 10% withholding tax charged on the repatriation of our earnings out of China. So the reporting tax impact depends on the amount of cash repatriated, and we plan to repatriate in a given year. But for the full year 2017, right now, we expect the effective tax rate to be no more than 30%.

**Operator**

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

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

Sorry, my line just dropped, so I'm not sure whether my question has already been addressed. So I got 2 questions on margins. So first of all, on the food and paper cost as a percentage of sales, it has been up by 1 percentage point during Q3. So I know -- I understand that the 1 percentage there was 1 percentage increase in the commodity costs. But this increase cannot fully explain the increasing food and paper cost. So is it true to say that we also increased our promotional intensity in that quarter? And if my guess is right, are we going to maintain a similar high level of promotional intensity in the future to boost things for sales growth? And the second question is on the occupancy cost. Actually, it has declined quite substantially during Q3 even if we start to lap the full benefits of the VAT reform. So apart from the same-store sales growth leverage, is there any other reason? Or actually, during our China check, we noticed that some of the landlords say that they only start to produce VAT tax invoices from this year. So are there still a little bit benefit from VAT in Q3 in terms of the occupancy cost?

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

Chen, I'll take the food and paper cost, and then Jacky will handle the occupancy cost. For the food and paper cost, for both business, we invest in Q3. For Pizza Hut, we have invest in the ingredients, the food quality, the portion. For KFC, we also invest because this year, it's 30 years. We are celebrating 30-year anniversary in China. Therefore, we have launched new campaigns to give very, very unforgettable promotion to our customer as a way to thank them. So what is our promotion? We sold original recipe chicken and (foreign language), the mashed potato at the price of 30 years ago. So you can imagine that is a very sincere way to say thank you. So that would have an impact on our food and paper cost. And for Q3, we did -- actually, we did that also earlier in the year for KFC. Yes. So the 30th anniversary certainly has an impact. And whether it will continue or not, we celebrate 30 years this year. But we always, always push ourselves to do everything we could to save cost or to push for new products, try to give the value back to customer. That's what we always do whenever we could.



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

And Chen, for your questions on occupancy, well, our rental expenses are actually relatively stable through proper portfolio management. And on utilities, we continue to innovate to be more efficiency -- to be more efficient. So in Q3, there was actually some slight savings. That's why you see a decrease.

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**Operator**

And the next telephone question comes from [Ya Xin Huang] from CICC.

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**Unidentified Analyst**

(foreign language) I have 2 questions. First on delivery. So what is the year-over-year delivery sales growth in third quarter in this quarter? And what percentage of sales comes from third-party platform like Meituan or Ele.me?

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

Okay. Let me try to give some color of the delivery. So for -- they are a bit different for both brands, so let me start with KFC first, then I'll go to Pizza Hut. So for KFC for the Q3 -- I mean, Christie can get back to you about the specific number but our growth of the delivery business is over 50%, Q3 for KFC. Therefore, year-to-year compared to last year's 3 quarter, I think it's in the slide, the percentage of delivery jumped from 8% to 11% for KFC. And in terms of the business from aggregators for KFC, it's about 50% to 60%. However, the key thing to remember is for KFC, while we get the traffic from the aggregator, we have our own riders to deliver our food. That's for KFC, for all our business so we deliver food ourselves.

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

Yes, [Ya Xin], just so you know, as a percentage of sales, KFC was 8% to 11% and Pizza Hut was 15% to 21% on a year-over-year basis.

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

And then for Pizza Hut, the growth of delivery is even higher because the base is relatively smaller for our Pizza Hut business. And then in terms of the percentage of business from aggregator, for Pizza Hut, it's much, much higher, too. It's about 70%, 80%. Why do I say a range? Because it's a bit different depending on whether we run promotions. So it's not sort of a steady number. It's always fluctuating a little bit. So for Pizza Hut, 70% to 80%, this is from aggregator, which we are trying to expand our own delivery rider and launch new Super-App so that we can increase the portion of our delivery business for our own Super-App for Pizza Hut, if that makes sense.

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**Unidentified Analyst**

And if I -- sorry, could I just ask another question? Yes. So second question is on marketing. So the shift (inaudible) change will be a big impact for the company?

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

(inaudible) Okay, I presume you're a fan. So -- he's a comedian. He represents our coffee business and particularly, our (foreign language) cafe, iced coffee. So coffee business is one of our business in KFC. I think for all the celebrities we are working with, they are all very, very good and they're all equally important. It's hard for to say who is more important than the other. But we like his sense of humor, and his sense of humor has done well for our K-Coffee.



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

Yes. And just to inform you, [Ya Xin], he was one of the spokesperson. Obviously, we have many different brands overall for all the promotions. In the interest of time, we will conclude our analyst call here. And then -- and if there are any follow-up questions, feel free to reach out to us. Thanks very much. Micky, do you want to...

**Operator**

Ladies and gentlemen, that does conclude...

**Muktesh Pant** - *Yum China Holdings, Inc. - CEO & Director*

Sorry, I just -- no, I just wanted to add my thanks to all of you for being on the call. I realize it's late on the East Coast, so I appreciate the U.S. folks staying up as late as this. I appreciate you might have more questions. But our Investor Day is just a few short weeks away. In Shanghai, we'll have a lot of chance to meet just over 100 of you, so we've got a chance to answer more questions in more details. Appreciate your support as always. Just a little anecdotal, you might have heard some noise on this call, and there is a big construction happening right behind our office. You can hear the pneumatic hammers. So if you ever wanted audible proof of investment in China, it's here. So we feel good about this business. And thank you for your time. And Christie, do you want to close the call?

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

Yes. Thank you so much. And we will follow up if there are any additional question. Operator, we can conclude the call now.

**Operator**

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

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