THOMSON REUTERS

EDITED TRANSCRIPT

Q1 2019 Yum China Holdings Inc Earnings Call

EVENT DATE/TIME: APRIL 30, 2019 / 12:00AM GMT

CORPORATE PARTICIPANTS

Florence Lip *Yum China Holdings, Inc. - Senior Director of IR*
Jacky Lo *Yum China Holdings, Inc. - CFO & Treasurer*
Joey Wat *Yum China Holdings, Inc. - CEO & Director*

CONFERENCE CALL PARTICIPANTS

Anne Ling *Deutsche Bank AG, Research Division - Regional Sector Head of Asia Consumer and Media Research*
Chen Luo *BofA Merrill Lynch, Research Division - MD*
Lillian Lou *Morgan Stanley, Research Division - Executive Director*
Michael A. Tamas *Oppenheimer & Co. Inc., Research Division - Associate*
Michelle Cheng *Goldman Sachs Group Inc., Research Division - Executive Director*
Sara Harkavy Senatore *Sanford C. Bernstein & Co., LLC., Research Division - Senior Research Analyst*
Xiaopo Wei *Citigroup Inc, Research Division - Director & Head of Asia-Pacific Consumer Research*
Yan Peng *UBS Investment Bank, Research Division - Executive Director & China Consumer Staples Sector Analyst*

PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the Yum China 2019 First Quarter Earnings Conference Call. (Operator Instructions) I must advise you that this conference is being recorded today, Tuesday, the 30th of April 2019. I would now like to hand the conference over to your first speaker today, Ms. Florence Lip. Thank you. Please go ahead.

Florence Lip ***Yum China Holdings, Inc. - Senior Director of IR***

Thank you, Rachel. Hello, everyone, and thank you for joining Yum China's First Quarter 2019 Earnings Conference Call. Joining us on today's call are Ms. Joey Wat, CEO of Yum China; and Mr. 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 call 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 cover Yum China's first quarter 2019 highlights; and Jacky will cover the financial results. We will then open the call to questions.

The webcast of this call will be available on our IR website. A PowerPoint presentation, which contains operational and financial information for the quarter, is available for download as well.

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, Florence. Hello, everyone, and thank you for joining us today. First, I would give an overview of the quarter before providing more detail on our operational initiatives for each of our core brands. I'm pleased to report that we delivered our 10th consecutive quarter of system sales growth since we spun off from Yum! Brands. Strong system sales growth of 9% was driven by accelerated new store openings, robust performance at KFC and a meaningful improvement at Pizza Hut.

In the first quarter of 2019, we continued to aggressively expand our market-leading footprint, opening 237 stores compared to 203 stores in the same period last year. Our new store openings continue to be dominated by KFC given the attractive cash payback period and strong growth opportunity. With excellent execution over the critical Chinese New Year period, KFC delivered an 11% increase in system sales and a 5% increase in same-store sales, successfully lapping 3 very strong first quarters with healthy growth across all city tiers.

We are also pleased to see the ongoing improvement at Pizza Hut which achieved positive 1% same-store sales growth, strong increase in traffic and significant margin improvement. Excluding the Wuxi remeasurement gain in the first quarter of 2018, we successfully achieved operating profit growth in the first quarter despite the margin pressure from rising poultry prices and wages. This reflects the benefit of sales leverage and our effective cost management initiative.

We were also very pleased to unveil our strategic partnerships with Sinopec sales company and CNPC at our Investor Day. Through these partnerships, we will jointly develop the gas station retail business which is an exciting example of the many untapped opportunities to grow our presence in China.

Now I will provide more color on the performance and strategy of our key brands, starting with KFC. KFC is the leading QSR brand in China and it continued to demonstrate its resilient business model. In the first quarter, KFC built on 3 years of strong growth with system sales up 11%, resulting in a 4-year CAGR of 9%, both excluding foreign exchange. Menu innovation, smart value, delivery and excellent execution drove strong same-store sales which was complemented by a substantial contribution from accelerated new store openings in 2018 and early 2019. KFC opened 191 new stores in the first quarter compared to 144 in the same period last year. Expansion will continue to be a key priority as we pursue additional opportunities for growth in attractive underserved markets across China.

Now let me talk about our special offers and menu innovation during the quarter. Based on the popularity of the Crayfish Burger during the 2018 LTO window, we successfully relaunched the burger ahead of the Chinese New Year holiday. The Crayfish Burger has become one of our unique signature products. Other innovative products launched included the shrimp burger and lotus leaf [wrapped] (added by company after the call) rice. We call it He Ye Fan in Chinese.

Turning to Chinese New Year. We meticulously planned for this crucial sales window for months in advance, and I'm very pleased to report we achieved very strong result on the back of innovative menu items, vibrant multilayered promotional campaigns and excellent execution. We created sharing oriented specials that are well suited to friends and family celebrating Chinese New Year together such as our spring festival golden bucket and wing bucket. We also implemented local marketing initiatives and decorated selected stores with Chinese cultural treasures by partnering with the National Museum of China.

In addition to Chinese New Year, we also catered to other Chinese festivals and regional specialties. For example, we served a green rice dumpling called Qing Tuan, which is an Eastern Chinese specialty for the tomb-sweeping holiday. We have found that customers are very receptive to regional specialties from all around China, and the rice dumpling proved to be a very popular product in many regions across the country.

We also maintained our focus on smart value. Given the success of our Crazy Thursday promotion in the second half last year, we are continuing to utilize this as our signature promotion. With an integrated approach to campaign planning and execution, this promotion succeed in driving strong incremental sales and profit.

In digital, we continue to focus on enhancing customer engagement by further integrating online platforms with offline stores. Our members grew to over 175 million by the end of the quarter, up 50 million year-over-year and up 15 million since the end of 2018. Members accounted for 49% of our sales already, up 11 percentage points on first quarter 2018. As we showed in our Investor Day presentation, our digital membership is driving significant increase in average spending per active user.

Digital payments account for about 87% of KFC sales in the first quarter, 13 percentage points up on first quarter 2018. In March, we also partnered with UnionPay to launch YUMC Pay Shen Qian Bao which will create another convenient payment option for our customers. We ran a successful promotion which generated strong social media buzz, app downloads, and most importantly, sales and member up-take.

Digital orders accounted for 55% of sales during the first quarter. One of our exciting new developments during the quarter was the national rollout of our AI-enabled personalized menus and recommendations for all mobile preorders. We saw a meaningful acceptance of trade-up recommendations. We will continue to refine this tool, and I believe it represents a huge opportunity to improve customer experience and satisfaction while also improving ticket average.

We continue to offer our privilege subscription program to build loyalty, consumer frequency and average spend. We sold over 1 million privilege program subscriptions in the first quarter of 2019. One of our popular options is our super privilege which combines delivery, breakfast and coffee privilege programs. This generates significant cross-selling opportunities. Delivery, Similarly, remains a key sales growth driver that caters to the evolving dining habits of Chinese consumers. We have began rolling out our improved dispatch system which we call Delivery 3.0. We expect the improved efficiencies and delivery quality enabled by ongoing enhancements to our delivery capabilities will support the ongoing growth of this key sales driver.

In the first quarter, delivery represented 18% of sales, up 4 percentage points year-over-year. As a result of our digital initiatives, the sales growth of delivery orders through own channels continue to exceed growth rates via aggregators.

KFC's commitment to smart value, continuous innovation in menu and daypart and leadership in digital and delivery has created defensible profitable growth. We will pursue an aggressive store opening program for the remainder of 2019.

Looking ahead, we remain very excited about KFC's long runway for growth in China. Next, I will provide some color on Pizza Hut's performance.

As we share in our Investor Day, we are continuing to implement the Pizza Hut revitalization program in 2019 with a focus on rolling out transformative initiatives at scale. We are pleased to see positive same-store sales and strong traffic during the quarter as well as a notable improvement in operating profit.

I will provide some more detail on Pizza Hut's performance in each of the 4 pillars that we have mentioned many times in the past, and they are fixing the fundamentals, driving digital, optimizing delivery and enhancing asset portfolio.

First, let's look at the fundamentals. A key component of our revitalization program is to improve our food taste and value-for-money perception. We launched our updated and streamlined new permanent menu in March. We have been systematically launching new limited time offers, or LTO, to trial new and improved menu options and adding the most popular items to the permanent menu. Products such as Australian beef pizza, steak platter and volcano cake, in Chinese we call it Bao Jiang Dan Gao, were notable additions. We enhanced key categories such as appetizers, pasta and drinks. Our key Chinese New Year special was the enormous thin crust 4-in-1 Pizza, Ju Da De Pi Sa, to cater to holiday sharing occasions. This generated excellent buzz on social media. We also offered customers great value for money with combo meals targeted at small and large groups.

We are very focused on improving our value-for-money perception, introducing new value items and implementing a series of value-based promotions. Following the pilot in December last year, we launched our signature value promotion Scream Wednesday or Jian Jiao Xing Qi San nationally in January. Selected items were offered at RMB 19, RMB 29 or RMB 39 every Wednesday. We have seen positive results with the campaign generating excitement and driving new customers and incremental sales. We will continue building the Scream Wednesday platform in 2019, introducing new products with disruptive value.

Our consumer feedback scores for both value for money and most preferred Western casual dining restaurant continued to improve during the quarter. We are also making progress with a number of efficiency initiatives enabled by disruptive technology, our large digital membership and our scale. During the quarter, we significantly improved labor productivity and lowered our cost of sales while maintaining and improving our service and food quality. This led to an improvement in margin, which Jacky will elaborate on further in a moment.

Next, let's look at digital. Pizza Hut continues to make rapid progress by implementing learnings from KFC, which is the digital pioneer in the restaurant industry in China. We launched our digital membership nationally going back to 2017 for Pizza Hut. And by the end of the first quarter this year, we have over 55 million members, up 15 million year-over-year and 5 million since the end of 2018. Our family privilege program launched late last year had proved very popular as well with over 1 million members. We have observed a meaningful increase in frequency and sales for members. We plan to build on the success in the rest of the year with new co-branding partnership and new offers.

Pizza Hut also ran promotions in conjunction with UnionPay to promote the YUMC Pay as well. This campaign was also very successful in driving new member acquisition, new app downloads as well as sales in both dine in and delivery.

Turning to delivery. We continue to see double-digit growth, and it accounts for 24% of Pizza Hut sales already, up 2 percentage points year-over-year. Growth in delivery orders through our own channels significantly outpaced growth via aggregators. During the quarter, we completed the installation of dedicated delivery area in about 75% of our dining restaurants. These areas help to provide faster service to our delivery customers without disrupting our dine-in customers. As we previously highlighted in the fourth quarter earnings call, we have taken back control of last-mile delivery with all of our orders now being fulfilled by our own team of dedicated riders.

Pizza Hut has also begun rolling out our latest delivery dispatch system, Delivery 3.0. Combined, these 2 initiatives are driving significant improvement in KPIs such as on-time delivery, complaint rates and customer satisfaction.

Lastly, we continue to enhance our asset portfolio through accelerated remodels and multiple store formats. To provide a more comfortable and stylish dining environment, we target to do 500 remodels in 2019 and to complete the refresh of our entire portfolio by 2021. We refurbished 28 stores in the first quarter, and we'll accelerate the pace in the rest of the year. We have further optimized the cost of refurbishment, and we are seeing a positive response from customers with the post-refurbishment sales uplift. We built 34 new stores in the first quarter of 2019, compared to 41 in the same period of 2018. Together, these revitalization initiatives are having a positive impact on the brand in the short term and long term. It's encouraging to see the same-store sales growth in the first quarter. Yet more work needs to be done to sustain the positive trend given the scale of the business and the competitive environment.

Lastly, turning to our new standalone coffee concept, COFFii & JOY. The concept added 5 stores in 4 new cities in the first quarter, taking us to 18 stores and doubling the number of cities we are in. We also entered into an agreement with WeWork, one of the leading co-working office space providers in China to provide coffee in 15 offices in Shanghai and Beijing. As we outlined in our Investor Day, the coffee market is a large and attractive segment in China, and we will leverage our strength in our supply chain, new store developments and digital capabilities to capture this new opportunity. We are continuing to test different formats and remain excited about the potential of this category.

With that, I'll hand over the call to our CFO, Jacky, who will cover our financial performance in more detail.

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

Thank you, Joey. Good day, everyone, and thank you for joining us. Let me quickly go over our first quarter 2019 financial results. Total revenues reached $2.3 billion in the quarter, up 10% year-over-year, excluding foreign exchange translation. Total system sales grew 9% year-over-year, ex FX, primarily due to strong same-store sales growth and accelerated new store openings at KFC as well as improving sales at Pizza Hut. We opened 237 new stores during the quarter, an average of well over 2 stores per day, and the majority were KFC stores. Our portfolio is now 8,653 restaurants as of the end of March 2019.

Looking at our current pipeline, we are confident that our gross new openings will exceed the top end of our original target of 600 to 650, and we'll provide additional detail as we get greater visibility on our second half pipeline.

During the quarter, KFC year-over-year system sales grew 11%, while Pizza Hut system sales increased 3%, both excluding foreign exchange translation. Yum China same-store sales increased 4%, with KFC same-store sales grew 5% despite lapping 3 consecutive years of positive same-store sales growth, and Pizza Hut achieved same-store sales growth of 1%, the first time since 2017 and a significant improvement compared to 2018.

During the quarter, KFC traffic increased 3% year-over-year while ticket average increased 2% year-over-year due to pricing offset by increased promotions. Pizza Hut traffic increased 8% year-over-year and was positive for both dine-in and delivery businesses as a result of successful value promotions and digital initiatives. Ticket average decreased 7% year-over-year as a result of our focus on driving value perception and the growing share of delivery.

KFC restaurant margin was under pressure at 20% versus 20.9% in the first quarter of 2018. Positive sales leverage and labor productivity improvement partially offset commodity inflation, including the previously flagged pressure from higher poultry prices as well as wage inflation and value promotions.

Pizza Hut restaurant margin improved to 14.3% in the first quarter, up 3.8 percentage points year-over-year. Significant efforts to improve labor efficiency and reduce restaurant operating costs in areas such as utilities more than offset the impact of value promotions and wage inflation. Overall, Yum China restaurant margin was 18.5%, up 0.6 percentage points compared to the 17.9% reported during the same period last year. Wage inflation was up 6%, while commodity inflation was up 3% compared to the same period last year, with poultry inflation being the major driver of commodity inflation. While we are actively working to manage the significant poultry price increase, we expect the impact will remain over the rest of 2019.

G&A expense was up 5% year-over-year, ex FX, up 3% when excluding one-off benefits in both periods. Our long-term goal remains to maintain a G&A expense growth rate lower than the revenue growth rate.

As a result of implementing the new lease accounting standard ASC 842 effective January 1, 2019, we conduct an additional impairment review in the first quarter resulting in an impairment charge of $12 million. Operating profit for the first quarter of 2019 decreased 23% year-over-year or $66 million. When excluding the gain of $98 million from the remeasurement of our previously held equity interest at Wuxi KFC in the first quarter of 2018 and the negative impact of foreign exchange translation due to the depreciation of renminbi against the U.S. dollar, adjusted operating profit increased 9% year-over-year.

For the first quarter of 2019, KFC operating profit increased 3% year-over-year and Pizza Hut operating profit improved 57%, both ex FX. Based on the release of final regulations related to the transition tax under the U.S. Tax Cuts and Jobs Act, we record a tax charge of $8 million in the quarter. Our effective tax rate during the first quarter, when excluding this transition tax charge, will be 26.5%. Our best estimate of the effective tax rate in 2019 continues to be below 28%.

Finally, diluted EPS was $0.57 in the first quarter of 2019 compared to $0.72 in the same period last year. Adjusted diluted EPS was $0.59 compared to $0.53 in the same period last year. The current quarter adjusted diluted EPS includes a mark-to-market gain of $0.02 per share from our equity investment in Meituan.

Next, let me cover our capital allocation strategy. In the first quarter of 2019, we generate net cash from operations of $344 million and free cash flow of $234 million after subtracting $110 million in capital expenditures. Our balance sheet remains strong with over $1.5 billion in cash and short-term investments.

With our healthy cash position, we returned $111 million to our shareholders in the first quarter including a cash dividend of $46 million and share repurchases of $65 million. There's approximately $900 million remaining under the share repurchase authorization as of the end of March 2019.

Based on our current quarterly dividend and existing share repurchase authorization, we have the capacity to return at least $1.5 billion to shareholders over the next 3 years, reflecting our confidence in our business model and our ability to generate cash.

Given our attractive growth opportunities and continued strong returns from new builds, our first priority will continue to be reinvesting in the core business with CapEx for the full year expected to be in the range of $450 million to $500 million.

Looking forward, we remain very excited about the long-term opportunities in the China markets. We will drive same-store sales growth and leverage our leading development capabilities to expand our store network. However, please note that KFC's exceptional same-store sales performance in the first quarter was primarily due to very strong execution during the Chinese New Year period and it may be difficult to replicate that level of growth through the remainder of the year.

As I previously discussed, pressure on margins from higher poultry prices is expected to remain over the rest of the year. Of course, we will look to mitigate this impact as much as possible by leveraging technology, our scale and our efficiency initiatives.

At Pizza Hut, we are very encouraged by the progress of our brand revitalization program, but do note that there may be quarterly fluctuations as we continue to roll out the initiatives at scale and the revitalization takes hold. In the first quarter, better matching of labor to demand during the Chinese New Year period led to an improvement in restaurant margin that may not be repeated in subsequent quarters. In addition, the aggressive program of 500 remodels during the year will put pressure on sales and operating profit in the short term, but this is an important component of the long-term revitalization of the brand.

With that, let me turn it back to Joey briefly before we open up the call to questions.

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

Thank you, Jacky. So to sum up, the 2019 got off to a good start with strong execution during our critical Chinese New Year sales period. I want to take this opportunity to thank our operations team who are at the front line of our business as well as all the supporting functions for their hard work.

KFC continues to perform strongly, has a very resilient and dependably profitable business model and is well positioned to manage market uncertainties. We see a long runway for growth for KFC as we continue to add new units across the country and drive same-store sales growth through daypart expansion and delivery.

We are seeing multiple positive signals in our revitalization of Pizza Hut with positive same-store sales, significantly improved traffic and improved profitability as well as positive trends in customer feedback. We know there's more work to do, but we remain confident in the revitalization plan of Pizza Hut.

At our Investor Day in March, we outlined our commitment to our vision of becoming the world's most innovative restaurant company and demonstrate that the powerful impact that innovation has on driving growth. By adapting to our customers' needs and utilizing new technologies, Yum China is focused on relentlessly driving defensible profitable growth. For those of you who were not able to join us back in March, I encourage you to review the presentations and webcast available on our webcast.

With that, I will pass you back to Florence to start the Q&A. Thank you.

Florence Lip ***Yum China Holdings, Inc. - Senior Director of IR***

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from the line of Sara Senatore from Bernstein.

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

I just wanted to follow up on a comment you said on demand environment. We heard from another Western QSR saying that it also has seen an intensified competition around value, but that is also seen as stabilization and improvement in its own trends. I'm just trying to reconcile what I think we're hearing about the environment with a couple of data points, let's say, that companies themselves are doing better. So do you think you're seeing something where sales players are taking a lot of share from slower independence? Is it local contests that are losing some of that traffic? And is the distinction -- is it a better value proposition that you're offering? Is it the digital piece? So I'm just trying to understand how it is that the environment is getting more competitive, but your businesses are improving.

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

Thank you, Sara. The -- it's very difficult to comment on the environment, but the good news is, we definitely have seen KFC continue to be a very resilient business model in a range of demand environment. From competitors' side or in the market we -- or from the customer demand, we certainly see the customer demand for good value products. But that's not enough. What we have learned in the last few decades is the combination of fantastic products and great value. So it's the combination that gives great value for money for the customer. And then at the store, it's the execution, it's the day-to-day operation. So for us, we just continue to focus on what we are good at and what we see customer want is great product, great value, really good operations, exciting marketing campaigns and then of course, supported by the digital innovation which comes in both marketing and operations. So it's a combination of the key value proposition that our customer wants. It's very hard to single out 1 particular reason really. So I hope that gives you a feel of the competition that we are in and what we do to please our customers really.

Operator

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

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

Congrats for the good results. My question is about the coffee operation, especially for KFC. We noticed that in the first quarter, the food cost increased significantly. And as you have been mentioned, the chicken price, we'll continue to see the pressure. But also understanding -- from third quarter last year, we launched this Crazy Thursday events. So is it possible to help us assimilate the impact between this value-for-money promotion versus the chicken price impact? And also I think earlier, we guided full year like low single-digit commodity inflation. Are we still maintaining this expectation?

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

Jacky, do you want to...

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

Yes, well, Michelle, maybe I'll just give you some additional colors in terms of the KFC restaurant margin in this quarter. I can go through line by line. So overall, if you look at KFC restaurant margin, it was down about 1 percentage point year-over-year. So we've mentioned both on the Q4 earnings call as well as the Investor Day, poultry inflation will put some pressure on the restaurant margin. So initially, we said at least in the first half of 2019, but right now, based on the current trend, we expect it will be -- continued for the remainder of the year. But overall, obviously KFC has a sales leverage from the 5% same-store sales growth in Q1, but that was offset by inflation and promotions, for example, like Crazy Thursday.

So let me give some additional colors line by line. So first on food and paper costs. Since the Crazy Thursday promotion was so well received by customers, we continued the promotional activities in Q1. So that actually put some pressure on the margin on the food cost. But commodity inflation was also mid-single digit this quarter due to the increased poultry prices which is higher than the typical low single-digit we saw in prior quarters. And on labor costs, so there was obviously labor inflation, it was high single digit, and we have worked very diligently on the labor productivity and also employee efficiency to offset that impact. And so looking forward in terms of chicken price, the market price were up about 30% year-over-year, but for KFC, we managed to keep the price increase at low double-digit in Q1. So with our long-term relationship with our suppliers, we were able to negotiate lower than market price increase during times of very high poultry inflation and we also benefit a bit from lag effect due to the inventories from the chicken we procure in the fourth quarter of 2018. So as I just mentioned, the commodity inflation was about 5% this quarter, which is higher than normal, and so we expect this continue for the rest of the year. But keep in mind, poultry is only one of many commodities in KFC, and we will continue to optimize our product mix and look for alternative cuts of chicken or alternative protein. So and look, I mean, we face inflation every year and price volatility is nothing new to us, so we have managed it very well for the last 30-plus years. But in terms of your question on inflation, so in this quarter, wage inflation was about 6%. So high single-digit for KFC and low single-digit for Pizza Hut -- mid-single digit for Pizza Hut and commodity was 3%. So as I just mentioned, it was 5% for KFC and a slight deflation for Pizza Hut. So looking forward, we've maintained the guidance that we provided. So for the full year, we still expect low single-digit commodity inflation and a high single-digit labor inflation.

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

Thank you, Jacky. Michelle, maybe I'll provide a little bit more color on this one. So for our Crazy Thursday promotion, since last year, we have been able to find products with very good cost economics, therefore, we are able to maintain the margin despite the challenges of poultry price increase and, as Jacky mentioned, we will continue to find the alternative products to promote during the Crazy Thursday. And of course the Crazy Thursday, the sales leverage helped the margin as well. So net-net, it worked out, and we'll continue to manage that for the rest of the year. Thank you, Michelle.

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. I just wanted to talk about the Pizza Hut margins a little more. You had great margins in the first quarter. So I'm just wondering how much of that can actually continue throughout the year? Or were there some very specific things that are siloed to the first quarter that aren't going to repeat for the rest of the year?

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

Sure, Mike. So if you look at Pizza Hut restaurant margin, it was up almost 4 percentage point year-over-year. So again, let me go through it line by line. So in terms of food and paper cost, our investment in promotional activities and value campaign such as Scream Wednesday has been very critical component of our strategy to drive traffic and over value for money to customers. So with a step up in value promotion in this quarter, so we are very pleased to see that Pizza Hut restore positive same-store sales growth and continue to see significant traffic growth. But obvious that put some pressure on our restaurant margin for the short term, and the sales leverage and commodity deflation have to offset the impact of the value promotion. So on labor cost, labor inflation was mid-single digit year-over-year, and we have significant improvement in labor productivity during the quarter. But some of this is ongoing, a significant portion is related to better managing of labor and sales during the critical Chinese New Year period, which I talked about earlier during the prepared remarks. So and on occupancy and other costs, there are a few components in this line item, but the improvement mainly came from a combination of savings and utility from lower utility price and the efficiency management and also less depreciation expense from the orders stores impairment we got from the prior years. So in addition, I want to point out one point. Before we took back control of a last-mile delivery in the latter part of 2018, the rider cost were amounts we paid to aggregators and they were recorded under occupancy and other cost, for example, in Q1 last year. But with the delivery being handled by our own dedicated riders now, the rider costs have been improved under the cost of labor, for example, in this quarter.

So looking forward and for the remainder of the year, over at the high level, we'll just continue to drive labor productivity and improved in-store efficiency, reduce restaurant operating costs and manage and tighten cost of sales to offset all the value promotions that we will take and also wage inflation. However, due to the one-off items I just talked about, for example, the labor productivity. So keep in mind, we have very low base last year. We talk about that extensively on Q1 last year's earnings call. So the year-over-year improvement is expected to taper off and also the utility savings that we talked about, we expect that impact to reduce in the second half of the year. So also, we are adjusting the business model and we have a very clear and deliberate strategy in the short term to drive traffic through investment in promotions. So I just want to reiterate at this point our strategy is to restore traffic and sales, followed by profit. But in the longer term, as the revitalization takes hold, we are very confident in restoring the margin back to the revitalization level.

Operator

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

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

Congratulations on the solid Q1 results. Just now we commented that KFC is very strong, same-store sales growth in Q1 can now be an indicator for the full year same-store sales growth. But in fact, heading to the coming 2 quarters, we actually are facing a very easy lap. So what actually makes us give a pretty cautious guidance of same-store sales growth for the rest of the year? Is there anything that we have seen, i.e. competition or other factors, that actually makes us a bit cautious? And also related to that question, given the rising pressure of the chicken cost, are we actually going to reduce the promotional intensity, especially in view of the easy lap to keep up better balance between same-store sales growth and margins for KFC?

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

Thank you, Luo Chen. For the lapping, for management, there's no such thing called easy lap, to be honest. If we look at the 3 years CAGR, Q1 for KFC, the last 3 years, was 5%, and Q2 actually, for 3 years CAGR was actually 4%. And then if we look last year number, last year, we have very exceptional Q1, and then Q2 was relatively flat as well. So we are quite cautious. Over 3 years' time, the lapping is still not so easy, it's still a challenge. So we just sort of have a cautious -- have a bit of caution about the simple extrapolation of the trend for Q1. The business -- particularly for KFC, the momentum is good. The business is doing well and it has proven to be very resilient. But we must always be prepared to respond to unexpected conditions rapidly. Of course, our business is structured and agile to do that, but we still have to be cautious. Regarding your question about less promotion given the high-poultry price, as Jacky mentioned earlier, as I mentioned earlier, the way that we support the Crazy Thursday, basically there are 2 ways to support it. One is we look for products that have very good cost economics. So that is a win, win, win situation. It's a win situation for us. It's a win situation for supplier. It's a win situation for customer. Alternatively, we will look for some sort of ingredient that probably has not been used before like Xiang Gu Ji which we tried that in the last quarter. So we are looking for sort of exciting product with good cost economics that please the customers. Driving traffic is very important, and as I mentioned at the very beginning of first question responding to Sara, smart value is still very important to our customer as we have seen from last year and the Q1 this year. So we'll manage the balance of the sales and margin, but I just want to emphasize, smart value was exciting product. It's still incredibly important for our customers.

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***

Congratulations on strong result. My question is focused on the restaurant margin. If we look at the restaurant margin of both KFC and Pizza Hut, we are seeing that the occupancy and other operating expenses to sales which actually were down year-on-year at each of the division. My understanding, it is benefit from the strong delivery and also your value efficiency may be some smaller size of new stores which opened last year. So I'm seeing this component were offsetting the negative impact of the higher poultry cost pressure looking forward. Shall we see this kind of trend will continue in the next few quarters mitigating the impact of the commodity cost and also accelerate openings in the rest of the year?

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

Yes, Xiaopo. So first, first of all, let me just give some additional colors on the occupancy and other costs. So this line item actually include a few component. So advertising and marketing expenses, utility expenses, rental expense, depreciation expense, the license fee we pay to YUM! Brands and all the other miscellaneous restaurant-related costs. So the improvement in this particular quarter was mainly due to obviously sales leverage and also I talked about earlier the utility savings from lower utility price and the efficiency management which we started last year. And also, there's less depreciation expense after the stores impairment we talked in prior years. And also for KFC, there was savings in advertising marketing expenses because we're shifting from the traditional mass media to a digital and targeted marketing. And I touched on this briefly earlier, also for Pizza Hut, you see a significant improvement, it's because we took back the last mile of the delivery. So there was a classification difference quarter-to-quarter. So in last year's Q1, all this delivery riders costs were in occupancy and other costs. In this quarter, it's in cost of labor. And looking forward, we expect some savings in occupancy and other costs in the first half of 2019, but it will gradually reduce due to the lapping year-over-year. And in terms of poultry, initially, we expect the inflation to be high in the first half, and then it will gradually tail off in the second half. But right now, looking at the current trend, we expect maybe there will be some continuous pressure for the rest of the year, but occupancy and others I already talked about, the impact will taper off. So it may not necessarily like offset each other.

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

Xiaopo, I sense your assumptions behind the question is whether the smaller store has some correlation with all these savings. I think generally, we can have that assumption because for the new stores that we are opening in both KFC and Pizza Hut, we certainly go into direction of smaller, faster and more delivery-friendly stores. And as you can imagine, with smaller stores or faster store, basically smaller store, and we -- management has done a lot to reduce the investments per store. So the combined effect is lower depreciation, lower rents, lower utility just because we are more strategic about the type of the new stores that we are opening. So I think if my sense of your assumptions behind your question, I would say, yes, generally there's such correlation. I hope we answered your question or my assumed question -- or your question.

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

Yes, so Joey, I just want to clarify. So why I asked the question is because last year, we have accelerated the opening. And Jacky also mentioned in the presentation that we will accelerate the openings this year as well. But if we look at the fourth quarter results for the margin, actually we didn't see a lot of impact on the restaurant margin due to new opening as we've seen other global retailers in the same scenarios. That's why we asked the question.

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

Yes, Xiaopo, I mean, maybe I can answer this and then Joey can elaborate as well. So I mean, yes, we talked about us continue to accelerate new builds for KFC. So the main reason is to capture market share. So that has to drive the strong system sales and the operating profit you see in this quarter, the significant growth. But all these new units, especially in China because of our first-mover advantage, but also they will be dilutive due to the time it takes to nurture these stores and until maturity. So they will be some short-term pressure on the restaurant margin for sure from all these -- from these accelerated new unit development strategy. And also, for Pizza Hut, I mean, I want to also talk with the remodel since because we talked about we've got to aggressively remodel about 500 stores this year. And in the first quarter, we only remodeled about 20x stores. So there's still over 470-plus stores that we have not remodeled. So right now, we are looking at maybe way towards Q2 and Q4. We'll actually ramp up the remodel because Q3 is the summer rush period. So we want to maybe scale towards Q2 and Q4. So obviously over the years, we have improved the speed and the cost of the remodel, but nonetheless, it's going to put some pressure on sales and operating profit. Yes, so because that will be lost sales for a period of time.

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

During the time, we closed the stores for remodeling.

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

Yes. Also, overall, series of new builds, let' say, remodels, all of these initiatives will put pressure on the margin.

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

In the short term...

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

In the short term, right. Yes.

Operator

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

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

Most of the questions were answered. So I have a bit follow up on Coffee because I think, Joey, since March, the Corporate Day, I think the company formally put coffee as 1 pillar for growth in the long term. So I know that you share a little bit more information about the progress, but could you give us a little more idea in terms of cups of coffee sold year-to-date compared to last year. And also, you start to do office delivery type of coffee. Is this under COFFii & JOY? Or is it under K-Coffee? Or actually are we're doing both?

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

For the Q1, the cups sold the index was 126. So that's very nice for KFC. This is for KFC. And then for COFFii & JOY, we have not started kind of that way yet because it's still early days. We look at how many stores we open. We have opened 5 more stores for Q1. So right now, we are at 18 stores all together. So for delivery, we have been doing delivery for COFFii & JOY and K-Coffee, but mainly K-Coffee really. So for -- Lillian, just your question about delivery, just want to make sure I answer your question, are you more curious on the C&J part or the K-Coffee bit?

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

I think both.

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

Okay. K-Coffee, we've been building K-Coffee since 2015, and we're very pleased to see the scale of the business and the growth rate, and the proposition is mainly Yi Bei Hao Ka Fei is a cup of good coffee with good price. So we will continue to drive it in KFC, and we'll strengthen the branding bit because we can see the potential in it. And delivery has been part of the business because we deliver K-Coffee together with breakfast and other foods. And for C&J, the coffee delivery business is still early days, really. We are figuring out the business model as we speak. So it's a bit early, but we do some kind of -- we do delivery. We also mentioned in my presentation earlier that we work with WeWork. So the coffee in WeWork is not delivery. We actually have our lovely coffee machine with the beans that produce coffee in the WeWork offices in Shanghai, and later on, it will be Beijing. So as you can see, because C&J is such a new concept in terms of business, in terms of our store model, business model, delivery model or even B2B model, we're still exploring, and we'll report that when we have more concrete conclusions, and then we'll roll it out if we are convinced that. I hope I answered your question on that, but further -- more detailed question, our IR team can follow up with you afterward. I'm curious nobody asked about Pizza Hut.

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***

Just want to check on, in the call and also during the Investor Day, you mentioned a couple of times regarding like the use of alternative protein. Is that the new category that you're going to come out? Or would you elaborate a little bit more on what is that, that will help ease some of these chicken price increase?

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

Sure. Well, Anne, in the Investor Day, we mentioned about, let's say, Xiang Gu Ji which is the -- a part of chicken that we somehow have not used in the last 30-some years, which is always amusing to ourselves. So that is the piece of chicken between the chicken wing and the chicken breast. So we will continue to explore with the introduction of the new technology we can find another way to cut our chicken and to introduce very good cost economic product to our customer. But I'll give you another example. For example, shrimp and crayfish. I mean traditionally, these are pretty expensive protein, but relatively, chicken price right now certainly they look fine and the economics work out again. I'll give you another example, it's coming soon, so I'm happy to do the advertisement here. We're going to -- possibly have some effect in our product, probably in the breast. So other than our famous chicken breasts, we are going to introduce the duck breast. It just seems logical with the flavor that we already established and explore with customer. So these are some examples that we can share at this point. And then we, of course, continue to search for other alternatives, alternative proteins, alternatives such as seafood or duck, et cetera, to make our customers happy. I hope that makes sense.

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

Yes, yes. Definitely. And on Pizza Hut, on the same-store sales trend, now that we have a positive for this quarter, do you think that we should be seeing a continuous improvement that will more stabilize that same-store sales is more sustainable? Or like we might still see some volatility throughout the quarter?

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

Thank you for entertaining me by asking me a question about Pizza Hut. Well, of course, we are quite happy to see the positive sales turn finally happen. It's a very clear sign of the good momentum of the business turnaround. What I want to comment is, when we embarked on the revitalization journey back to May 2017, we have focused on 4 areas which we are all familiar with right now. And 4 areas that we work on, they're all, what I will call short-term painful, but long-term beneficial to our business. So back to 2017, 1 of the 4 pillars is the delivery is really delivering very good same-store sales that lift the entire business. By 2018, the improvement of the delivery is no longer enough to support the decline in dine in. But we continue to focus on the other 3 pillars such as digital, such as FX and the fundamentals such as menu. And all 4 area in terms of the painful changes have bear fruit. What I want to say is the 2018 -- 2019 Q1, the momentum is aggregated result of some fundamental changes in all 4 areas. Delivery-wise, it's not only just promotion. We integrate. We took back the last-mile delivery, and we integrated Pizza Hut service and Pizza Hut dining, and we went all the effort to put dedicated delivery areas in 75% of our dining assets. So these are all very, very big and fundamental change. And then fundamentals such as in the menu, the menu originally we have 120 items on the menu. For the new menu, we introduced March '18, there were only 77 items. And among the 77 items, only about 1/4 of them are from the previous menu. The rest of the product on the 77 items are either new products that we launched over the last 2 years through LTOs and proven to be good products or upgrade products. So again, huge effort to reduce the menu and to upgrade and to improve the 3/4 of the menu. And then we come to the digital side, we start the Super APP. We launched the membership program. Now we are at 55 million, and then we launched the privilege program, significantly improved the digital capability of Pizza Hut. And last fundamentally is the assets. We look at alternative design, and we start to modernize the store and then we have many innovations in our store business models -- store models as well. So all these are fundamental changes. For your question about whether the positive change can sustain or not, it's very hard to predict the market uncertainties. What we can control is the fundamental aspect of the business that we can change. And I would like to believe that we have such fundamental change of the business will help in the short term and the long term. But our business, the seasonality is a factor in our business. So the quarterly fluctuations might happen but in the long term, we are confident in our business for Pizza Hut. Thank you, Anne.

Operator

Your last question comes from the line of Christine Peng from UBS.

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

Congratulations on the great results. I have 2 questions regarding the store opening strategies of KFC and Pizza Hut. Regarding KFC, so Joey, in your earlier presentation, you mentioned about the gas station plans with one of the oil companies in China. So can you elaborate the details in terms of the number of stores, in terms of the stores -- revenue contribution, profitability, et cetera, and what's different between these stores and the traditional stores KFC has? I think that's the first question I have. The second question is regarding Pizza Hut. So basically, first quarter is a very strong quarter. I think it's also better than management's previous guidance. So given this situation, would you consider opening more Pizza Hut stores going forward? And I think you mentioned about hub-and-spoke model on your Investor Day. So what is the new thought behind this?

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

Thank you, Christine. For the strategic partnership, there's a little bit update since our last meeting at the Investor Day. As you recall, we have entered into exclusive rights in franchise business with CNPC, but we also get the right of first refusal for both Sinopec and CNPC for about 20 years. And we also share our prudent approach that we want to figure out the business model first before we become specific on the economics and the details. And right now the update, we are testing 1 store and then we are identifying more suitable locations. So the aim is to open 100 stores in the next 3 years. So I understand that this is a modest goal given the fact that both great companies have 50,000 gas station over China. But we believe once we taken the gas station, we do have the credibility and ability to scale up pretty quickly. What's the difference between old and new? The first difference I can imagine is it will be -- it's likely to be slightly smaller than our sort of normal store. But at the same time, within our store business model, we have 8 or 9 business model, and we do have the small store model already. So the size-wise probably will be sort of smaller and then it will be sort of more very, very focused on the convenience. As you can imagine, speed is important in this kind of location. For the details specific, we are testing it right now. For the Pizza Hut, you're right to point it out that the store opening plan or number is related to business performance. As you can see historically in KFC's number, we opened 191 stores this quarter, we opened 144 store last year Q1, and we opened 85 store Q1 the year before, if I remember my numbers correctly. So you can see as the business improve, we do ramp up the new store openings. So Pizza Hut for this year we have modest target for the new store openings, but if the business improves, obviously, according to our own internal new store opening target and more pipeline can pass the requirement, then might have more stores will be -- more store might be opened. But I mean Jacky had mentioned in various occasions usually we will have more visibility of the new store opening numbers after Q2, during the second half of the year. For your question about hub and spoke, we are excited about innovations in store models. That's an important part of the business. So this is one of our innovations this year. And so far, I can report that we have about 15 hub-and-spoke stores opened already, but all of these stores are open -- have only been open for less than 3 months. So there's still a lot to learn and a lot to tweak. But the initial observation is positive. As you can imagine, the smaller store, lower investment, give us more flexibility to open stores in different trade zones, and that flexibility is always good for business with our scale. So I think that's what I can report for the time being. So by next early release when we have more visibility, hopefully we can share more. Thank you so much, Christine.

Florence Lip ***Yum China Holdings, Inc. - Senior Director of IR***

Thank you, everyone. Thank you, Christine. Thank you, everyone. Thank you for joining the call today. We look forward to speaking with you on the next earnings call. That concludes today's call. Have a great day. Thanks, Rachel.

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

Thank you, guys. Thank you all.

Operator

Ladies and gentlemen, that concludes our call for today. Thank you for your participation. You may now disconnect.