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PRESENTATION

Operator

Thank you for standing by, and welcome to the Yum China First Quarter 2023 Earnings Conference Call. (Operator Instructions) I would now like to hand the conference over to Ms. Michelle Shen, IR Director. Please go ahead.

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

Thank you, Ashley. Hello, everyone. Thank you for joining Yum China's First Quarter 2023 Earnings Conference Call. On today's call are our CEO, Ms. Joey Wat; and our CFO, Mr. Andy Yeung.

Before we get started, I'd like to remind you that our earnings call and investor materials 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. Reconciliation of non-GAAP and the GAAP measures is included in our earnings release.

You can find the webcast of this call and a PowerPoint presentation on our IR website. Now I would like to turn the call over to Joey Wat, CEO of Yum China. Joey?

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

Thank you, Michelle. Hello, everyone, and thank you for joining us today. We are pleased to have set new records for first quarter revenue and operating profit. It's a wonderful start to 2023, like the Chinese saying, (Kai Men Hong). I want to thank all of our 400,000-plus employees. Without their hard work and dedication, our performance will not be possible.

System sales grew 17% year-over-year. Back in early January, we had low visibility into how conditions will unfold after the relaxation of strict COVID measures. Chinese New Year is a critical trading period for us. This year, an earlier Chinese New Year was particularly challenging due to shorter ramp-up period. We planned for multiple scenarios incorporating regional differences and focused on driving sales based on the more optimistic scenarios. Therefore, we were able to effectively deploy resources as opportunities emerged.

Operating profit more than doubled to $416 million. Our efforts in enhancing operational efficiency and rebasing our cost structure in the past few years contributed to strong profitability in the quarter. And our system sales growth compared to 2019 is plus 20%, and operating profit also compared to 2019 is plus 37%. These results exemplify our ability to stay resilient in challenging times and seize opportunities when better times emerge. Our initiatives and investments, along with our Resiliency, Growth, Moat, strategy have made us more agile and responsive.

During the quarter, we were encouraged by early signs of recovery, notably, dine-in, takeaway, delivery all grew year-over-year on a same-store sales basis. Delivery accounts for around 36% of sales, same as a year ago. Customers continue to love the convenience that

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delivery provides. Off-premise was over 60% of sales. Same-store sales grew year-over-year across different regions and trade zones. We benefited from increasing mobility and saw a 40% plus growth at transportation and tourist locations. However, same-store sales at these locations in the first quarter were still 20% to 30% below 2019 level.

Weekend sales growth slightly outpaced weekday sales. Apart from increased social gatherings, value programs since mid-2022 also contributed to growth. Let me share about how we drove sales. We focused on our core pillars, good food at great value and good customer experience to capture demand.

Good food at great value is our hallmark. We refreshed several signature products and achieved great results.

After doing it for more than a decade, people come to expect our Chinese New Year bucket at KFC. To capture at-home consumption around family reunions, we add the option to trade up for a juicy whole chicken, (Quan Ji). We sold 11 million whole chickens in the first quarter, more than doubled year-over-year.

We gave our classic Beef Wrap a localized spicy twist, (Mao Xue Wang Neng Niu Wu Fang). The innovation sparked social buzz leading to a sellout in many markets in just 6 days.

At Pizza Hut, the Supreme series is our most popular pizza lineup, accounting for nearly 30% of all the pizzas we've sold in the first quarter. We introduced Wagyu Beef and Seafood Supreme, (Xian Tiao Qiang He Niu Chao Ji Zhi Zun) in Chinese New Year. By including premium ingredients like abalone, sea cucumber and wagyu beef, these pizzas became the perfect, festive choice. We also created Double Durian Supreme, (Shuang Chong Liu Lian Chao Ji Zhi Zun). For durian supreme, two types of durian, (Su Dan Wang/Jin Zheng) were combined with grapefruit and pineapple to create an explosive tropical flavor. Durian lovers love it.

We continue to make our good food available at great value. At KFC, Crazy Thursday and Sunday's Buy More, Save More promotions, (Feng Kuang Xing Qi Si, Zhou Ri Feng Kuang Ping), continued to drive sales momentum and excitement. This year, we offered these great values even during Chinese New Year. We also revamped our weekday's value combos, (OK San Jian Tao), with more choices and lowered prices of select burger combos to just RMB 19.9. These 3-items combos attracted new customers and drove frequency. We also expanded our popular buy one, get one free campaign at Pizza Hut to include pizza and steak options. Customers can redeem the free item immediately or in their next visit within 30 days. The campaign significantly increased sales by encouraging repeat purchases during the promotion period.

Now let's talk about operating efficiency. Late last year, a significant portion of our employees and riders were infected with COVID. At the peak, over 4,000 of our stores were temporarily closed or offered only limited services. By early January, as people gradually recovered from COVID, we made every effort to keep our stores open and resume normal operations.

We got ready for the Chinese New Year period. We planned for crews and inventory based on the more optimistic scenarios. We also accounted for regional differences and continuously fine-tuned our plans based on regional learnings. We further improved hiring and incentive program to manage staffing and minimize labor shortages. To enhance productivity, we expanded our initiative to share store management teams across multiple stores. It also provides career development opportunities for our young talents.

Now let me share with you about our digitization. We have built a powerful digital ecosystem that's instrumental to our innovations while also enhancing operational efficiency. We leveraged AI to optimize demand forecasting, inventory management, crew scheduling and production. Smart order system, (Zhi Neng Ding Dan Jiao Fu), streamlined the food preparation for dine-in and off-premise orders. These capabilities are particularly important during the peak season like Chinese New Year. Also, migrating our key infrastructure to private YUMC's cloud enhanced the reliability of our operations. It's especially important when we face significant traffic spikes during campaigns like Crazy Thursday.

Smart delivery, (Zhi Neng Shang Quan), continued to improve delivery coverage and flexibility. Last year, we upgraded the system to dynamically adjust delivery coverage for each store by daypart. These capabilities, along with our dedicated delivery riders, allow us to capture more sales and fulfill orders even during the Chinese New Year peak season.

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We continued to improve digital touch points for better engagement with members. Digital orders accounted for around 89% of sales in the first quarter. Our loyalty programs exceeded 430 million members. Members steadily contribute to about 60% sales. We actively engage members and drive frequency with privileged subscription plans. K-Friends, (Zhi You Ka), is an invitation-only program for top 1 million loyal customers. K-Friends received exclusive coupons and perks and a royal crown on the call screen when ordering in stores. This help us gain valuable insights to improve service for our most loyal members and all customers.

To sum up, we are extremely pleased to deliver strong first quarter performance. Multiple scenario planning, innovative products and value campaigns, along with our agile supply chain and digital capabilities, enable us to capture market opportunities. As we progress through 2023, we plan to stay nimble to the evolving market conditions. Looking ahead, we will focus on building sales momentum, expanding our store network and fortifying our competitive moat.

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

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

Thank you, Joey, and hello, everyone. Let me now share with you our first quarter performance. First quarter sales rebounded significantly from the fourth quarter. We made tremendous efforts to drive sales since the reopening by offering innovative food and compelling value campaigns.

Restaurant margin reached 20.3%, the highest since 2017. Our margin expansion was driven by sales leveraging, efforts to rebase our cost structure in recent years, investments in improving operating efficiency and temporary COVID-related relief from government and landlords.

Let's go through the financials. Foreign exchange had a negative impact of approximately 8% in the quarter. First quarter total revenues were $2.9 billion in reported currency, a 9% year-over-year increase. In constant currency, total revenue grew 18%. System sales increased 17% year-over-year in constant currency. The robust growth was fueled by same-store sales growth of 8%. The contribution from new units and significantly fewer COVID-related temporary store closures. Both KFC and Pizza Hut achieved 17% system sales growth.

By brand, KFC same-store sales grew 8% year-over-year. Same-store traffic grew 6%, and ticket average grew 2%. Pizza Hut same-store sales grew 7% year-over-year. Same-store traffic grew 13%, and ticket average decreased 5%. These results were largely due to the successful promotional activities, which drove strong traffic and lowered ticket average.

Restaurant margin was 20.3%, 650 basis points higher than the prior year. Sales leveraging contributed to approximately half of the margin expansion. Labor productivity gains and lower occupancy costs were key factors. We also enjoyed $18 million benefit from additional VAT deduction, thanks to the government policy to help businesses deal with the challenges posed by COVID-19. These are partially offset by cost inflation and increased promotion expense.

Let me go through the key items. Cost of sales was 30.1%, 100 basis points lower than prior year. We kept commodity prices low through tremendous efforts locking in prices and innovating the menu. We also reduced wastage and benefited from higher VAT deductions. Gains were offset by increased promotional activity to drive traffic.

Cost of labor was 24.6%, 160 basis points lower than the prior year. Sales leveraging and better labor productivity more than offset headwinds from low single-digit wage inflation. We further improved labor productivity through store management team and crew-sharing initiatives.

Occupancy and others was 25.0%, 390 basis points lower than the prior year. This was mainly driven by sales leveraging, lower rental expense as well as other cost saving initiatives. Rental expense improved due to relatively more favorable rental terms for new store and store portfolio optimization.

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We also recorded $8 million rental relief related to COVID surge last year. G&A expense increased 16% year-over-year in constant currency, mainly from performance-based bonus and merit increase as well as additional travel expenses from the resumption of business activities. Operating profit was $416 million, increasing 118% in constant currency -- sorry, in reported currency. Our effective tax rate was 28.5%. We expect full year effective tax rate to be around 30%. Net income was $289 million, increasing 189% year-over-year in reported currency. Diluted EPS was $0.68, an increase of 196% year-over-year. In the first quarter, we generated $507 million in operating cash flows and $328 million in free cash flows. We returned $116 million to shareholders in cash dividends and share repurchases. At the end of the first quarter, we had around $3 billion in cash in short-term investments and another $1 billion in long-term deposit, which would benefit from better interest rates. We expanded our store network and remained committed to capturing future growth opportunities.

In the first quarter, we opened 233 net new stores. In the first quarter, we faced an earlier Chinese New Year and labor shortage as well as delayed contract signing and building permit process due to the widespread infection in the fourth quarter. However, we have a strong pipeline and are confident in reaching our goal of opening 1,100 to 1,300 net new stores this year.

Our new stores continue to perform well with payback periods of 2 years at KFC and 3 years at Pizza Hut. We will continue to focus on expanding our store network in a systematic and disciplined manner.

Let's turn to our outlook. We're encouraged by first quarter performance. Sales during the Chinese New Year trading period were buoyed by pent-up demand to travel. But same-store sales post Chinese New Year has remained at teens level below 2019. Now we are still in the early stages of the recovery. The pace and the trajectory of the recovery are likely to be gradual and uncertain. Overall, global macroeconomic conditions remain challenging, and the pandemic is still lingering.

So the fact that -- so the top priority for us this year is still driving sales. Consumers are value conscious, so our investment in promotions to attract more traffic and sales are crucial. In the coming quarters, we expect gradual inflationary pressure, and we anticipate the benefits from additional VAT deductions and rental relief to phase out. We have demonstrated our ability to capture opportunities in good times and manage the downside in bad times. We will continue to utilize extensive scenario planning, flexible cost structure and operational agility to navigate the uncertain environment. We remain committed to seizing the long-term growth opportunities in China, investing in strengthening our strategic moat and creating value for our shareholders.

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

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

Thanks, Andy. Before starting the Q&A, we'd like to share a head up that we have scheduled our 2023 Investor Day on September 14 to 15. The event will take place in Xi'an, China, and it will also be webcast for those who can't join us in person. We will provide more details soon.

Now we will open the call for questions. (Operator Instructions) Ashley, please start the Q&A.

QUESTIONS AND ANSWERS

Operator

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

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

Congrats for the very strong results. My question is about the value campaigns you mentioned on the call just now. So since we have been going through this reopening for the past few months and given we see the trend is still quite challenging, so can you share with us what is your thinking about the consumers' spending power and strategies on the product mix?

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And related to this question is about the food cost. So we see a pretty decent improvement on the food and paper cost savings. But if we look into KFC versus Pizza Hut, it looks like the KFC benefit quite a lot on these cost savings, while Pizza Hut did not see that much benefit. So can you also share with us how this value campaign and the product mix adjustment impact the 2 brands for cost?

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

Thank you. Thank you, Michelle. Let me comment on the value campaigns and then Andy can follow up with the cost comment. There are economic challenges right now. And therefore, consumers are quite value conscious. The key question here is what are our strategies? They're 3-pronged -- 3 pillars of our strategy. One is menu. We really focus on the food that's tasty and innovative food on top of value campaign because the pure value campaign is not enough. The value campaign must come with good food in order to get the benefit. So you will see the new Beef Wrap with Maoxuewang and that is right after Chinese New Year value campaign product. And that was doing very well.

And then the good value, of course, is important. So you can see we have -- KFC, we have the Crazy Thursday. And we add weekday value combos right now. And then on top of that, we introduced (Zhou Ri Feng Kuang Ping) campaign, the Sunday value campaign since middle of last year. And all of these were quite well. So we'll continue to work on that because, let's not forget, sometimes -- Crazy Thursday has been working since 2018. So it takes many years' hard work to build that as a platform. And then with Pizza Hut, we have this Scream Wednesday, which has been working quite well.

On top of good food, good value, we have good fun. We, even right now, delight customers with some fun toys or even lucky draw to a trip to Maldives, et cetera. So that's the first pillar of the strategy.

Second is pricing. When we raise price, we always do it very, very carefully and prudently. And we also carefully design trade-up options to protect the ticket average and margin. So while we are going heavy with the value campaign, you can see management team has been able to protect the margin for the shareholder. And on top of that, we introduced good selection for each price range, including entry price point products and let the customer choose.

The third pillar of the strategy is to keep the cost competitive in inflationary environment. Our supply chain has been doing amazing work to secure supply and product innovation at scale. So while these value campaign seem amazing marketing campaign, well, they are amazing, but these are not possible without the very strong pricing behind that. And then we also drive operational efficiency, including staff sharing, lowering the food waste and then also save a lot of money from rents in order to pass the savings back to the customer. I'll pause here and I'll pass to Andy for comments related to cost.

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

So yes, so I think when you look at Pizza Hut, we're very encouraged and very happy with the results. If you look at the same-store growth for Pizza Hut, we saw 7% same-store growth. And then if you look at overall system growth, it grew 17%. Pizza Hut also have seen acceleration in store openings. At the same time, we also see very strong margin expansion. We saw almost 350 basis point restaurant margin expansion. And if you look at the operating profit itself, it's almost double, like 85% increase on a year-over-year basis, which is slightly less than KFC, which is 90%, but still very respectable.

And I think when we look at the cost structure on a line item basis, obviously, the 2 business are slightly different in the way they operate and also the material that they use. So when you look at the food cost, [Pizza Hut] (corrected by company after the call) obviously have more import product components, beef, cheese, dairy products, et cetera.

And then also for the 2 brands, they also have different sort of like pace of promotional activities. And if you look at Pizza Hut, you have very strong value campaign, and it drove very strong store traffic growth. And so I think the strategy, although slightly different for the 2 brands, are working quite well both at Pizza Hut and KFC. Thanks.

Operator

Your next question comes from Lillian Lou with Morgan Stanley.

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

Congratulations again, Joey and Andy, for the strong results. My question is actually on the cost side because I think Joey and Andy did mention that there are some benefits from cost rebase in the first quarter, significant margin improvement aside from the sales leveraging. And especially, I think if we look at -- look into the details, there has been significant savings on the depreciation and amortization compared to last year.

So my understand, going forward, what's the margin outlook on the year-on-year basis? Are we -- can we expect a similar pattern of cost savings from operation put aside the phasing out -- of release and also with your guidance on the depreciation cost for the full year, given the significant decrease in the first quarter.

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

It seems like another question for me so I will take these questions. So in terms of margins, I think when we look at first quarter margin improvement, we're very encouraged. Obviously, as we have expected, with the increasing sales, we're going to see sales leveraging. So approximately almost half the improvement are coming from the sales leveraging.

Now in terms of the overall cost structure, we can see that labor productivity, some of the efforts that we put into rebasing our cost structure there are benefiting the COL as well. So you can see that they're optimizing labor scheduling and labor mix and then we also have their initiative as we mentioned on the prepared remarks, restaurant management team and crew-sharing initiatives.

And then on the operating efficiency side, I think you would also see that benefits from less wastage because we have better sales forecast and real time inventory visibility. So that's the benefit of investing in technology, in digitization. We also have installed some smart utilization, smart utility devices in the restaurant, so we also see better utility usage.

In terms of -- you mentioned, in terms of our O&O expenses and depreciation, I think one is that the rental expense, as I mentioned before, we have relatively more favorable rental terms for our new store, and also we have a store portfolio optimization. That should also help us in terms of our depreciation. And then if you look at our overall investment for new stores, we also have better up front investments there, and that will also benefit in the long term our depreciating expense as well.

Now in the first quarter, we also benefited from some temporary relief. As I mentioned, $8 million from rental relief that we received from last year's COVID surge, and then also about $18 million from additional VAT deduction, which is a government policy that help business to deal with COVID challenges, and we will see how long that policy would continue.

In terms of outlook, I think one thing that I want to emphasize on is that, as I mentioned, sales is a very important factor in determining our overall margin. And so with sales improving year-over-year, we should see sales leveraging. However, I want to point out that we do have seasonality with our sales. First quarter is a solid quarter for sales and therefore, margin. The other one and is that our -- when we look at the pace of recovery, I think post -- as I mentioned, post pandemic and post CNY, we see a more gradual pace of recovery. And still, like if you look at the cost of goods sold, we'll have a relatively stable cost of sales with the commodity prices, but we're already seeing from the spot market that some of their increasing pressure building, although much more gradual compared to overseas.

We're also likely to see wage inflation through the year. And normally, we see mid- to high single digits. Currently, we're at low single digits. So I think we're going to trend back to normal as recovery continues. So that's a lot like the way we look at it. For margin improvement, I think, to a high degree, driven by sales leveraging. I think the cost structure rebasing initiative will continue to take hold, but some of the temporary relief would go away for the rest of the year.

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

Thank you, Lillian, I just want to add a few comments on the question. The current cost base is certainly more resilient than 3 years ago. Last 3 years have been difficult, challenging, particularly 2022. Therefore, we really have been pushing a lot to rebase the cost. And the result is showing right now.

Let me give you some specific examples. For the rent, it's better. It's actually the best rent in the last decade for 2 reasons. One is our

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store portfolio is better because we have been able to prune some low-performing stores while built new stores with much better rent structure. Think about over 40% of our stores were built in the last 3 years. For depreciation, roughly, even for just 2022, our CapEx for new store is down by 25% to 35% just for 2022. If we add up the improvement in the last 3 years, the improvement is more.

Well, the WPSA, the sales per week is also coming down. However, the profit margin maintained or even improved. And the benefit of lower CapEx is not only benefiting depreciation. Think about the sales side, Lillian. It also benefits the new store opening. With the lower CapEx per new store, we are able to open stores in trade zones that we will not be open -- we were not able to open in the past. But lower CapEx allow us to have more flexibility to open stores and still maintain the profitability.

And third one is the labor cost. I think this is an ongoing challenge. But as Andy mentioned, we have initiative working on crew sharing, starting with the delivery rider and now moving to store staff as well. And that is something that we'll continue to work on. And it's still quite early in the process, but we'll continue with that. Thank you, Lillian.

Operator

Your next question comes from Lina Yan with HSBC.

Hau-Yee Yan ***HSBC, Research Division - Hong Kong and China Consumer Analyst***

So I want to compare the recovery pattern on a same-store sales basis, first quarter 2023 versus first quarter 2021. So as you mentioned in your presentation, with off-line traffic recovered, you still see positive growth in delivery. This was actually different from what happened in first quarter 2021. So my question is, was this due to a structural shift in the spending pattern of consumers? Like dine-in might never come like a year to like 2019 level? Or it means with delivery still growing in the post-pandemic age, we actually have more room to grow our off-line traffic and dine-in service. Actually, we have like a bigger potential versus 2019 to grow our single-store sales. So that's my question. I hope I explained it well.

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

Lina, I don't understand your question. Maybe, Andy, you go ahead.

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

Yes. So thanks, Joey. So I think, obviously, in 2021 and today, it's quite different macro environment and also in terms of the overall COVID recovery. So at different times different place. I'm not so sure it's comparable just looking at 2023 versus 2021. What I can say is that if you look at delivery, delivery, we're -- and off-premise, in general, have been growing before the pandemic and continue to grow throughout the pandemic.

As we have mentioned in last quarter and with the reopening, we do expect dine-in traffic to rebound, but we also see that delivery remains very robust. I think we're looking at delivery sales overall last year, at the end of last year, because the pandemic, [delivery] (added by company after the call) spiked to about 39% of our sales. Now it is roughly about 36% of our sales. I think within that 35% up and down fluctuation, it is within our expectation.

Now we also benefit not just because the overall obvious consumers continue to get the favorite and the benefit from enjoying that benefit of off-premise dine-in, the convenience and whatnot, but also, we also benefit from our store network restructuring. You can think about that. We have mentioned over the past couple of years, we continue to build more entities within the city that we have already have stores, and with the store format that's more catering towards delivery and takeaway business. And so we are seeing some network effect there, right? So we'll benefit from that.

And then also, if you look at our delivery business model, it's very unique in a way that we deliver -- we have dedicated riders to deliver our food to consumer for the last mile. And that allow us to ensure good service quality, good food, timely manner. And then more importantly, when there's labor shortage in rider -- like Chinese New Year or what we have in Crazy Thursday, or rainy day, we do have ability to provide that to delivery services when others perhaps may not.

So overall, I know we also have continued to improve our trade zone. As we mentioned, we have invested in technology to help us to

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more effectively manage our trade zone for delivery and also the efficiency in terms of our delivery services, both in terms of food production process, queuing, and also trade zone routing for our rider. So I think digital delivery will continue to be a very important growth driver for us going forward. Obviously, with the rebound in store traffic, we may see a percentage change and fluctuate. But I think long term, we're pretty -- we're confident in off-premise dining. Thanks. Joey, do you have anything to add?

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

That's it. Thank you, Andy.

Operator

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

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

Congratulations again on the full year results. So my question is also related to same-store sales growth as I like to get more detailed color on the Q1 same-store sales. So first of all, our result announcement mentioned that after CNY, our same-store sales actually was below the 2019 level by teens level. So it seems that there could be some sequential weakness. But on the other hand, is it fair to say that on a year-on-year basis, or if we compare it with 2022 level, actually, in March, we are seeing even better year-on-year same-store sales growth as the Shanghai lockdown actually started from the middle of March in 2022.

And secondly, by city tier and regions, which parts have we -- have actually registered even better growth? Are we seeing better growth in Tier 1, Tier 2 cities or lower tier cities? Or in which regions, such as in Eastern China or Southern China? Which part of the regions actually have seen even better growth?

And also lastly, when it comes to dine-in, which was also the focus of the previous question by Lina. Apart from the fact that we mentioned that our stores in transportation hub and tourist locations still for 20% to 30% same-store sales decline versus 2019, are there any other drags that we have observed in terms of the same-store sales at the dine-in level? Is it because of too many new stores in our mature markets, which may cause cannibalization? Or are there any other drags? And how are we going to do to address these issues so that we can see further improvement of the dine-in traffic?

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

Thank you, Luo Chen. I'm going to address on the same-store sales, but let me also emphasize for -- our first quarter number is also equally to look at the system sales compared to 2019 because there's a gap of same-store sales versus 2019. But the system sales growth, as I mentioned from my opening remarks, is plus 20% versus 2019, and the OP is perhaps 37% versus 2019. So I think we like to focus on same-store sales, but it's equally important to note the impact of better store portfolio and also the new stores opened in the last 3 years.

I'm going to go through a bit more color of the same-store sales breakdown and then come back to the dine-in comment. We see strong rebound from quarter 4 2022, and we grow year-over-year. First 2 months in Q1, we benefit from the pent-up demand for Chinese New Year travel. But more than that, we have multiple scenario planning, and we invest heavily in both ingredients and staff -- staffing. Therefore, I believe we have a better-than-industry-average results.

After the Chinese New Year, the same-store sales continue to grow year-over-year. But yes, it remains teens below 2019. But the good momentum continues into quarter 2. So I think you can see from all the picture of May 1 holiday, the trading was vibrant. Still low single digits below 2019, but it's catching up quite nicely.

[As disclosed in 2023 Q1 10-Q, during the Labor Day holiday period, trading was vibrant and grew on a year-over-year basis, yet same-store sales were still approximately in the mid-single digits range below the 2019 level on a pro-forma basis.] (added by company after the call)

The encouraging sign is that the sales growth year-on-year is led by transaction growth in both KFC and Pizza Hut. And you know in our business, this is absolutely important. As I mentioned already, system sales improved significantly with much larger store network. But

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also, despite the same-store sales gap, the older stores are much healthier because we have been pruning store portfolio. And the new stores are more resilient because by redesigning the store network, as Andy mentioned before, and adjusting the store format to capture off-premise demand with more convenience, less investment, flexible cost structure. So net-net, it's more resilient -- the store portfolio.

So let's move on to the more specific, by brand, by region, by city tier, et cetera. So by brand, KFC and Pizza Hut same-store sales is similar. But versus 2019, it's interesting. The Pizza Hut same-store sales versus 2019 is slightly higher than KFC. It's -- Pizza Hut is minus 4 versus 2019 and KFC is minus 8. So it's partly because KFC has a higher ratio of stores in transportation and tourist locations. But also it shows that Pizza Hut had good improvement since its revitalization program.

KFC system sales growth higher than Pizza Hut because we've opened more new stores for KFC in the past few years. Therefore, it's plus 19% for KFC. By region, year-over-year, all markets grew for quarter 1, except Beijing because remember, last year, we had Winter Olympics. But by March, subsequently, the number improved and turned positive. Versus 2019, KFC Eastern China outperformed other regions because of its very vibrant economy. Pizza Hut Northern China outperformed because it has less competition. Our business of Pizza Hut in Northern China actually is quite strong. By city tier, year-over-year, lower tier cities performed well as people returned home for Chinese New Year. Tier 2 cities also performed well because last year, the control -- the strict control on COVID impacted the tourism. And this year, we are getting the benefit out of it because domestic tourism in cities like Changsha, Xian, Hangzhou helps a lot.

Transportation hub. Year-over-year, we see substantial improvement with increased mobility. The momentum, obviously, further improved during the May holidays. So I think -- I hope that gives you some color of the different angle of the same-store sales.

In terms of dine-in, it improves. It continued to improve because we have increased mobility after the COVID policy change. And it's important to see whether dine-in, delivery or take away, all the same-store sales improved. It's not only just focused on one. And of course, it improved more for Pizza Hut than for KFC because we rely more on dine-in business for Pizza Hut.

But I would like to ask you to look at the other side of our business, which is the resiliency. KFC, it took us a lot of hard work and determination to get the off-premise sales to as high as 60%, 70%. And that means it's a very resilient business model because even when dine-in were significantly impacted, we are able to still do the business and bring in sales.

Whilst Pizza Hut also improved a lot because the percentage of off-premise business for Pizza Hut in 2019 was only 30%. That's between takeaway and delivery. By 2022, that ratio is 50%. But back to 2023, now the ratio is down to 46%. But it would be very good for Pizza Hut if we continue to improve the ratio of takeaway and delivery because that improves the resiliency of the business. It's a good thing. So I hope that gives you some color of our thinking of the dine-in business versus the others.

Is there any other threat? Well, there are always much uncertainty. Particularly the macro environment, we can't forecast, we can't predict too well. But what I would like to remind our analysts is we have always have multiple scenario planning, and in the last 3 years, I hope we have also demonstrated our ability to deliver and to have the resilience in our business during bad times. And during the past quarter, we also have demonstrated our ability to seize opportunity during good times.

Are too many new stores a drag? Not really, from our point of view. Therefore, we are still sticking to our new store opening guidance because, as Andy mentioned again and again, we have very disciplined and systematic way of opening new stores.

And one thing I would also like to mention is -- and to emphasize is the agility and the flexibility of the new store portfolio is very important going forward because instead of investing too much money on big store, we are investing in smaller, lower investment stores, but with shorter distance between the stores, and to make it a more convenient network for the customer but also a lower cost of delivery network for the operation because it's more efficient and it's a lower cost to deliver our product to a customer when the stores distance is shorter and closer to the customer. Thank you, Lou Chen.

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

Joey, I just want to add a couple of 2 quick points there. One is that when we look at -- when we mentioned like we see low teens level compared to 2019 post CNY. But like if you look at CNY, we're also at the level below 2019. And I think the main thing is that what we're

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trying to say is that we saw a very sharp recovery after the reopening and during the Chinese New Year period then we see more gradual sort of like recovery -- recovery [post (CNY)] (corrected by company after the call).

The other one is what we mentioned is in SSG comparison. So our SSG calculation excludes the temporary store closure. And so -- but our system sales include same-store sales growth, temporary store closure and also net new store growth. Right. So when analysts and investors compare the SSG number, they need to factor in the impact of temporary store closure.

For example, this quarter, we have about 8% SSG. There's a few point impact from temporary store closure. So you add that back there, then you will see probably double-digit SSG improvement. And so I just want to make sure that people don't forget that a slightly different way of comparing SSG between us and from our peers. And so like if you look at the overall industry growth, we're probably going to and the overall dine-in industry. Thanks.

Operator

Your next question comes from Anne Ling with Jefferies.

Kin Shun Ling ***Jefferies LLC, Research Division - Equity Analyst***

Excellent results. But I have some questions on the cost side. Regarding the VAT benefit, maybe would you elaborate a little bit more the nature of this VAT benefit, which contributed $18 million for this quarter? And like what is the nature? Like -- and like, will the next few quarters will be seeing something similar? What is it based on? Based on cost of goods or particular like commodity or packaging product? So I would like to know a little bit more about that part.

And also, going back to the same-store sales number. So if we are talking about like same-store sales -- or sorry, is it fair to say that same-store sales growth recovery might actually take a bit longer to recover back to year 2019? Given the fact that especially in Tier 1 cities, you are increasing your store density. So meaning that we should be looking at like your new store -- your store growth rather than like fixate on the same-store sales number. Yes. So this is my second question.

And my third one is I'm still a little bit confused. You just mentioned about the CapEx decline was about -- on a per store basis, about 20%. But during this period, as Lina mentioned, the depreciation expense is actually down 41%. But of course, I do not know like whether there's any difference in any mix in terms of like the back-end CapEx versus the store front CapEx. So maybe you can help us understand a little bit more of this like excellent cost savings on your side.

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

I'll make a quick comment on the CapEx, Andy, and then you can continue. And the CapEx, the new -- the CapEx for new store down 20%, but we also save a lot of money from pruning the original store portfolio. And that's very important. So both the old store and new store helped. Okay? Andy, back to you.

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

Okay. So let me try to address the VAT deduction discussions. If you look at the Chinese government policy, the VAT deductions, the policy came out in 2019 and it covered some of the reductions for VAT input. However, because of the COVID-19, the policy has continued to be extended over the past couple of years. And now the policy is going to be extended this year. And depending on various situations in how the business operates, it may be benefits -- it may be able to be a benefit from the additional VAT deductions.

And so this policy, currently, as it stands right now, is extended to the second half of the full year. But the level of benefit that we may be able to enjoy may phase out. It has to do with how the input costs and how [high] (corrected by company after the call) the VAT value is. So it's a little bit complicated to talk about it on the conference call, but you can study the VAT policy from the Chinese government website.

The other one about the -- about, I think the depreciation and amortization cost difference. I think the one thing that we want to emphasize is that, there's 2 components to that. One is depreciation. The other one is amortization. The big drop there is coming from amortization, as we have mentioned, in the past years that when we acquired the controlling -- stake in Hangzhou, we also have a --

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reacquired franchise rights. And each quarter, it's roughly about like $15 million or so. And so that's one of the big factors there. And that basically expired at the end of last year. And so that's why we see that suddenly improve depreciation and amortization.

In terms of SSG recovery. I think it's -- we're only in the first quarter of recovery. So based on what other countries experienced, overall recovery to the pre-pandemic level will likely take time and it's likely going to be uneven. And certainly, as we mentioned, the pace and trajectory of that would be gradual and uncertain. And so if you look at the -- like I think, we'll be surprised to see the industry itself and also any large restaurant chain will rebound immediately to the pre-pandemic level in the first quarter after reopening.

But we are confident, as we have demonstrated in the first quarter, we're able to capture the opportunities when it presents itself. In Chinese New Year, I think despite a lot of uncertainty at that time, because of our planning, our team's agility and opportunities and our digital investment infrastructure, we're able to capture those opportunities as we have back then in 2021, when there's a market rebound.

Now obviously, we cannot predict, as Joey mentioned, what uncertainty are in the market, but we are also confident that given our cost structure rebasing initiatives, we have a more flexible and resilient business model. We can also deal with any potential downsides during this recovery. So -- but again, the recovery, we should expect to fully recover to pre-COVID level will take some time, and will be some up and down, but I think we're confident that either way, I'm thinking we're [resilient] (corrected by company after the call). Thanks, Anne.

Operator

Your next question comes from Christine Peng with UBS.

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

I think most of the questions have already been addressed by Joey and Andy. But if I can just ask a follow-up question on the depreciation side. I think many analysts have already asked this question, but I just want to understand a bit more why there is such a big drop in terms of depreciation expenses?

If you calculate on a year-on-year basis, it dropped by around USD 50 million. Andy, you mentioned there was a $50 million impact from the Hangzhou franchise rights. So other than that, are there any factors that investors should be aware of? Or should we consider this -- about USD 110 million depreciation expenses as recurring while we tackled in the full year depreciation expenses for the full year?

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

Christine, yes, let me address that. I'm sorry, I correct myself. The reacquired franchise rights, it's actually $25 million per quarter, as we mentioned before. And then for the full year, it's almost $100 million. And so the other one is, obviously, you got to remember our assets in China is based in China. And then so it will be impacted with the value and depreciation amount would be impacted by currency exchange. In the quarter, RMB depreciated against the U.S. dollar by almost 8%. And so that would have an impact on the balance sheet and also the depreciation because of currency translation as well.

And then finally, we -- as we mentioned before, we have also done some store optimizations during the pandemic, store format redesigning and such work. And obviously, we closed out some of the more challenging store. And so that also have an impact on the depreciation and amortization as well.

So all in all, so you can think about it by $25 million half-half, and then you have also almost like $15 million from foreign exchange and then optimizations in our overall store portfolio. And so all this impact adds up together to some $50 million reduction in depreciation and amortization. We will have more details in our 10-Q statement. So if you guys are interested in more, that's the 3 key factors that were driving depreciation and amortizing cost.

I just want to remind analysts and investors that don't forget the impact of foreign exchange. The foreign exchange has been pretty volatile over the past year. And as I mentioned, foreign exchange had a negative impact of 8% because of the RMB depreciation. So that will have an impact on P&L and also on the balance sheet. Thanks.

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Operator

Thank you. That is all the time we have for questions today. I'll now hand back to Ms. Michelle Shen for closing remarks.

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

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

Operator

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

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