

Yum China: A Tasty Addition

With over 1.42 billion people in the country, China's population represents approximately 17.7% of the world's population! Central to the daily life of these people is the enjoyment of good food. Many acquaint the Chinese food culture with chopsticks, teacups, and local restaurants serving families with bowls of steaming rice and noodles. Surprisingly, however, China's largest restaurant chain is a western brand that we all know, named KFC. KFC is owned by Yum China, which has over 13,600 restaurants in more than 1,900 cities across Mainland China. Astonishingly, Yum China is confident in further rapid growth as it plans to expand its store numbers to 20,000 by 2026. This article briefly documents the story behind Yum China's success in the Chinese market and follows by addressing the opportunities, outlook, and reasons why we hold it across global portfolios.



James
Clark

It may come as a surprise to many that China's largest restaurant brand is a western brand that we all know, named KFC. KFC is owned by Yum China, which is the country's largest restaurant company. Yum China was spun-off from Yum! Brands in 2016, separating the two companies into two independent entities.

Amongst its brands, Yum China owns KFC and Pizza Hut, both of which are western-styled brands that have succeeded in the Chinese market. The company also operates several emerging brands including Taco Bell, Little Sheep, Huang Ji Huang, and Shaofaner, most of which are integrated into Chinese culture. Additionally, Yum China also partners with Lavazza, an Italian coffee brand, to explore the coffee concept in China. The reason behind Yum China's success in China is fascinating and worth briefly explaining.

In 1987, Yum! Brands opened its first KFC restaurant in China. At that time, western-style fast-food was largely unknown to Chinese consumers. Despite KFC's success in America, the executives of KFC China firmly believed that departing from the company's US approach, which included limited menus, inexpensive prices,

SPEED READ

- Yum China has grown to become the largest restaurant company in China with over 13,600 stores in more than 1,900 cities across Mainland China.
- Despite the slow recovery in China, the reopening of their economy presents an opportunity for Yum China and has given the company clarity for its future growth.
- Last month, Yum China revised their guidance for restaurant expansion in 2023 to expand by 1,400 - 1,600 stores, up from the previous guidance of 1,100 - 1,300. The company aims to grow to 20,000 stores by the end of 2026.
- Yum China is a cash generative company with many prospects for future growth, including the large size of China's middle class, ongoing urbanization, and the capabilities of digitalization, which fits neatly into our global themes of the aspirational consumer and Chinese recovery.

and predominantly franchised restaurants offering take-aways, would enable the company to succeed in the Chinese market. Focus was placed on not being seen as a foreign restaurant chain, but rather on becoming part of China's local community. This focus transformed KFC China into a chain of restaurants that were mainly company-owned and managed by Chinese personnel, allowing for

greater local market knowledge and flexibility. Menus catered to local taste preferences, offering items such as pork, rice dishes, and soy milk, in addition to its popular fried chicken offerings. Similarly, Pizza Hut also underwent a transformation from its original western style to become embedded in Chinese culture.

Yum! Brands expanded its presence in China by entering small and midsize cities, often securing prime locations as it benefited from first mover advantage. Additionally, the company also set up its own reliable supply chain with company-owned warehouse centers and a fleet of distribution vehicles to reach every province in China. This firm foundation that was laid by the management team in its early years enabled the company to rapidly expand. Yum China is now the largest restaurant company in China, with more than 13,600 restaurants in over 1,900 cities across mainland China. These restaurants span every province and autonomous region within mainland China.

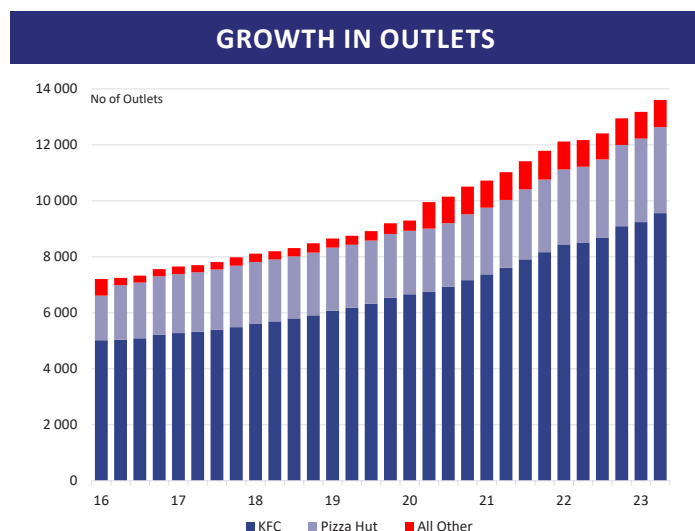
In recent years, Yum China has resiliently faced

real estate issues plague the economy, and general cautiousness is reflected in the overall spending patterns of the country's consumers. Although restaurant businesses are not exempt from these economic challenges, evidenced by the discounts and promotions offered by restaurants to drive sales, we remain convinced that there are many opportunities presented for Yum China.

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Despite the slow recovery, the reopening of China provides an opportunity for Yum China. The management team have observed a willingness from Chinese consumers to pay for good, convenient food that provides instant gratification and an interesting experience, despite the slowing economy and difficult job market. Continued urbanization and government policies aimed at encouraging consumption growth in the country may also spur increased demand for restaurant and fast-food consumption. Additionally, pent-up travel demand within the country gives rise to further opportunity. The reopening of China has also given Yum China clarity for the future. Focus has shifted from ‘resilience’ to ‘growth’ as the more predictable environment has led the company to revise some of its growth targets for the years ahead.

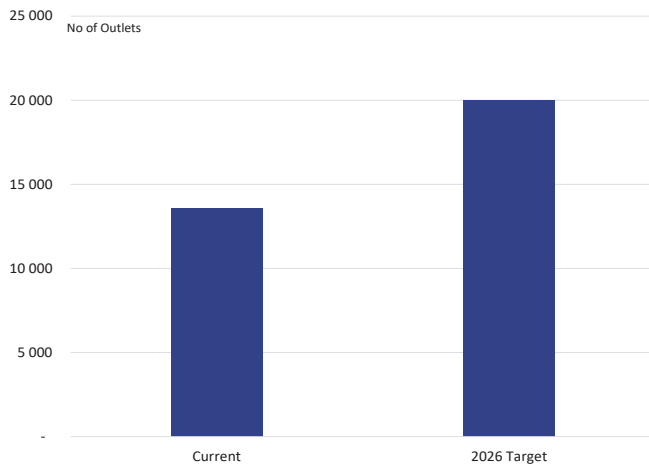
Last month, Yum China hosted an investor day in China. Management announced their revised guidance for restaurant unit expansion in 2023 to expand by 1,400 - 1,600 stores, up from the previous guidance of 1,100 - 1,300 announced at the beginning of this year. Management also restated their bold goal of expanding their overall restaurant count to 20,000 by 2026. This goal



After a single restaurant in 1987, Yum China's restaurant network now stands at over 13,600 outlets in more than 1,900 cities across Mainland China, spanning every province and autonomous region within the country.

the difficult Covid period in China. As recent data has shown, China's recovery from its challenging Covid years has not played out as anticipated. Youth unemployment is elevated,

RESTAURANT EXPANSION GUIDANCE



Yum China aims to expand total restaurant numbers to 20,000 by 2026.

roughly equates to an addition of 1,800 stores each year until the end of 2026, which works out to be almost five new restaurants being added in China each day! The company evidently believes in their ability to rapidly expand in the coming years, seeing ample opportunity to achieve this growth. Yum China's opportunity for restaurant expansion is captured by a fast-growing addressable market. The sheer scale of the Chinese economy, large size of China's middle class, and continued urbanization in the country are great opportunities for growth. Despite being well-positioned in more than 1,900 Chinese cities, Yum China has its eyes set on a further 1,100 untapped lower-tier cities across the country. Interestingly, KFC and Pizza Hut's urban population served per restaurant in mainland China is among the highest relative to KFC and Pizza Hut stores in other countries. This indicates that there is room for further store openings without risking cannibalization of sales from existing stores. The company aims to penetrate these lower-tier cities by accelerating franchising and introducing new, smaller restaurant formats that are delivery-focused and have been proven to be less capital-intensive, creating the potential for cost reduction and improved efficiency.

Speaking about efficiency, Yum China has developed sales resiliency and operational efficiency over the past few years by embracing digitalization. The digital side of the business was

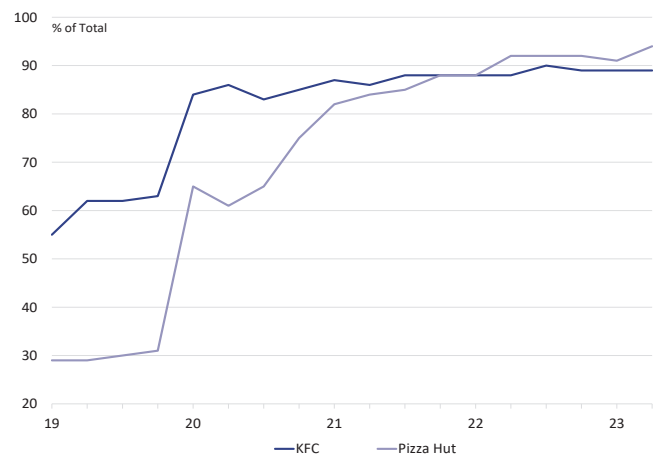


Shanghai, China

accelerated during Covid, to the extent that digital sales now make up over 90% of the company's total sales. These digital sales are achieved through digital means such as mobile orders and consumer-facing kiosks.

In addition to this digital technology, Yum China also incorporates AI technology within its supply chain and business operations, including real-time inventory management, integrated kitchen management, and robotic servers. Staggeringly, Yum China has achieved 80% growth in its store numbers since 2016, while its number of employees has remained flat over this period, implying improved efficiency. Yum China continues to view digitalization as an opportunity as consumers focus more on experiential consumption, and AI technology enables greater optimization within the company's operations.

DIGITAL SALES AS A PERCENTAGE OF TOTAL SALES



Yum China has built sales resiliency over the past few years by embracing digitalization, which was accelerated by Covid.

Other opportunities for Yum China and its investors include a growing Chinese coffee market. The company established a joint venture with an Italian coffee company, Lavazza, in 2020. Lavazza has made encouraging progress and now has over 100 stores in China with plans to reach 1,000 stores within the next three to five years. Furthermore, as part of the company's long-term outlook, Yum China stated a target to return a total of \$3 billion to shareholders over 2024 to 2026, through increased dividends and share buybacks. This represents an 80% increase from the period between 2021 to 2023.

In conclusion, Yum China is a dominant company within the Chinese restaurant industry. From a

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financial perspective, the company is cash generative and has produced strong returns since its spin-off from Yum! Brands. Management have proven their resiliency and adaptability by navigating the company through the challenging Covid years. Despite the slow

recovery, the company now stands to benefit from the reopening of the economy as continued urbanization, government policies aimed at encouraging spending, and pent-up travel demand have the potential to fuel further consumption of their products. Furthermore, the reopening of China has given the company fresh impetus, evidenced by their revised growth objectives. That makes it an exciting holding for global portfolios.



*Pizza Hut and KFC outlets stand next to each other in China.
Both brands are owned by the country's largest restaurant company, Yum China.*



Our next Insight seminar will take place in December in Cape Town, Johannesburg and Howick. After an eventful 2023 which has delivered its fair share of surprises, our next seminar will take stock of the year and focus on the outlook for 2024.



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Topic: **Outlook for 2024**

Natal Midlands

Date:	7th of December
Venue:	Oasis Conference Centre, 72 Main Road, Howick
Morning Time:	10am for 10.30am
Evening Time:	5.30pm for 6pm

Johannesburg

Date:	6th of December
Venue:	Rosebank Union Church, Cnr William Nichol and St Andrews Road, Hurlingham
Time:	7am for 7.30am

Cape Town

Date:	4th of December
Venue:	ABRU Motor Studio, Lourensford Wine Estate, Somerset West
Time:	5.30pm for 6pm

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