

Yum China (YUMC US / 9987HK)

Top player in China's catering market

- The Group is the top player in China's catering service market in 2019; KFC, one of the portfolio brands, was ranked first in China's QSR market; Pizza Hut and Huang Ji Huang took up the first two spots in China's CSR market
- As of end-Sep 2020, the Group's restaurant count reached 10,150, of which 6,925 were KFC and 2,277 were Pizza Hut
- The Group plans to grow the number of restaurants to 20,000, or more than twice of the restaurant count as of end-2019
- Our projected FY19-22E revenue CAGR is 7.2%
- Initiate with **BUY**; current TP represents 46.63x/36.16x 20E/21E P/E, or 5.04x/4.57x 20E/21E P/B

A dominant player in China's catering service market. KFC, one of the Group's portfolio brand, was the number one player in China's QSR (quick service restaurant) market in 2019; Pizza Hut and Huang Ji Huang were the top two players in China's CSR (casual dining restaurant) market in 2019. In 9M20, KFC and Pizza Hut accounted for 91.3% of the Group's total revenue.

Room for expansion in the restaurant market. According to Frost & Sullivan (F&S), the total market size (by revenue) of China's restaurant market is expected to grow at a CAGR of 7.2% in 2019-24E; the total market sizes (by revenue) of China's QSR and CDR markets are expected to grow at CAGRs of 8.3% and 7.9% in 2019-24E.

Strong track record. The Group was able to maintain an average SSSG (same-store sales growth, excluding currency translation impact) of 3% in FY16-19. Although business suffered in 1Q20 due to the COVID-19 pandemic, recovery has been seen in the following quarters.

FY19-22E revenue CAGR at 7.2%. FY20E results will be affected by the pandemic, which disrupted the Group's operation mainly in 1H20. We expect KFC's FY19-22E revenue CAGR to be 8.0%, while that of Pizza Hut would be 0.2%. We also project the Group's OPM and NPM (to shareholders of the Company) would increase to 12.9% and 9.9% for FY22E.

Initiate with BUY, TP at US\$ 71.8/HK\$ 556.8. Our DCF model yields a TP at US\$ 71.8/HK\$ 556.8, which represents 46.63x/36.16x 20E/21E P/E, or 5.04x/4.57x 20E/21E P/B. Initiate with **BUY**.

Risk factors: 1) Macroeconomic risk; 2) Regulatory risk; 3) Operational risk; 4) Cost risk; 5) Concentration risk; 6) Seasonality risk; 7) Non-GAAP financial metrics; 8) EPS dilution.

Results and Valuation

FY ended Dec 31	FY18A	FY19A	FY20E	FY21E	FY22E
Revenue (US\$ mn)	8,415	8,776	8,159	9,495	10,822
Chg (% YoY)	8.3	4.3	(7.0)	16.4	14.0
Net profit (US\$ mn) ⁽¹⁾	708	713	645	832	1,076
Chg (% YoY)	77.9	0.7	(9.5)	28.9	29.3
EPS (US\$)	1.84	1.89	1.54	1.99	2.57
Chg (% YoY)	78.6	2.7	(18.5)	28.9	29.3
BVPS (US\$)	7.48	8.16	14.26	15.72	17.78
Chg (% YoY)	4.7	9.1	74.7	10.2	13.1
P/E (x) – US	32.74	31.88	39.12	30.33	23.46
P/E (x) – HK	33.06	32.19	39.49	30.63	23.69
P/B (x) – US	8.05	7.38	4.23	3.83	3.39
P/B (x) – HK	8.13	7.45	4.27	3.87	3.42
ROAE (%)	16.5	12.9	7.6	7.8	9.1
ROAA (%)	25.1	24.0	14.3	13.3	15.3
DPS (US\$)	0.44	0.48	0.24	0.48	0.48
Yield (%) - US	0.7	0.8	0.4	0.8	0.8
Yield (%) - HK	0.7	0.8	0.4	0.8	0.8

Source(s): The Group, ABCI Securities estimates

Company Report

Initiation

Nov 20, 2020

Rating (US): BUY
 Rating (HK): BUY
 TP (US): US\$ 71.8
 TP (HK): HK\$ 556.8

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Price (US/HK)	US\$ 60.25/HK\$ 471.6
Est. price return (US/HK)	19.21%/18.06%
Est. dividend yield (US/HK)	0.4%/0.4%
Est. total return (US/HK)	19.61%/18.46%
Last Rating & TP (US/HK)	N/A
Previous Report Date	N/A

Source(s): Bloomberg, ABCI Securities estimate

Key Data

52Wk H/L (US\$) (US shr)	60.92/38.33
52Wk H/L (HK\$) (HK shr)	482.4/385.6
Total issued shares (mn)	419
Issued US shr (mn)	377
Issued HK shr(mn)	42
US-shr market cap (US\$ mn)	22,726
H-shr market cap (HK\$ mn)	19,765
3-mth avg daily turnover (US\$ mn) (US shr)	133.27
Avg daily turnover since IPO (HK\$ mn) (HK shr)	274.74
Major shareholder(s) (%): Invesco	9.89

Source(s): Bloomberg, ABCI Securities

Price performance – US (%)

	Absolute	Relative*
1-mth	14.11	9.41
3-mth	10.35	3.77
6-mth	23.59	(0.04)

*Relative to S&P 500 Index

Source(s): Bloomberg, ABCI Securities

Price performance – HK (%)

	Absolute	Relative*
1-mth	14.80	7.44
3-mth	N/A	N/A
6-mth	N/A	N/A

*Relative to HSI

Source(s): Bloomberg, ABCI Securities

Note:

1) refers to net profit to shareholders of the Company ;

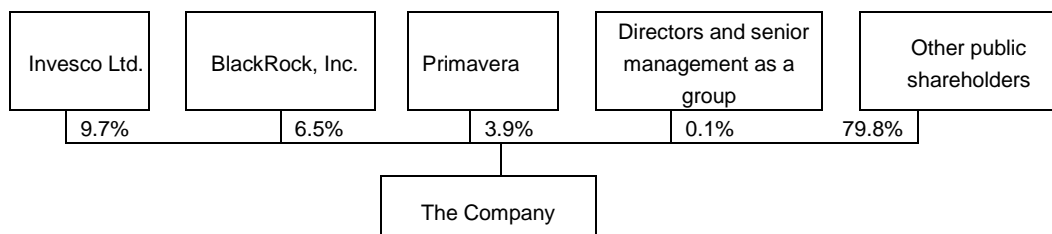
2) US\$/HK\$= 7.7525;

3) Market data as of Nov 19, 2020

Listed on HKEX at HK\$ 412.0/share

The Group was listed in Hong Kong on Sep 10, 2020 at HK\$ 412.0/share. No overallotment option was exercised and the total proceeds amounted to ~HK\$ 17,002mn. The Group's other public shareholding was 79.8% immediately after the listing.

Exhibit 1: Shareholding structure immediately after the HK listing



Source(s): The Group, ABCI Securities

According to the Group, the proceeds from the HK listing would be mainly used for expansion of restaurant network, and investments in (i) digitalization and supply chain, (ii) food innovation and value proposition, and (iii) high-quality assets.

Exhibit 2: Use of proceeds

#	% of total proceed	Usage
1	45	Expand and deepen restaurant network
2	45	Investments in (i) digitalization and supply chain, (ii) food innovation and value proposition, and (iii) high quality assets
3	10	Working capital and general corporate purposes

Source(s): The Group, ABCI Securities

Investment highlights

1. Leading player in the QSR and CDR markets in China

The Group operates multiple brands of restaurants in China. Major brands in the Group's portfolio include KFC and Pizza Hut, which contributed to 70.3% and 21.0% of total revenue (include company-owned, franchise, and unconsolidated affiliate restaurants) in 9M20. The remaining brands are Little Sheep, Huang Ji Huang, COFFii & JOY, East Dawning, Taco Bell, and Lavazza restaurant units. As of end-9M20, the Group's restaurant count reached 10,150, which included 6,925 KFC restaurants and 2,277 Pizza Hut restaurants.

FY ended Dec 31	2017	2018	2019	9M20
Revenue (US\$ mn)				
KFC	5,066	5,688	6,040	4,222
Pizza Hut	2,093	2,111	2,054	1,259
Revenue contribution (%)				
KFC	65.2	67.6	68.8	70.3
Pizza Hut	26.9	25.1	23.4	21.0

Source(s): The Group, ABCI Securities

FY ended Dec 31	FY17	FY18	FY19	9M20
Number of restaurant counts				
Number of restaurants	7,983	8,484	9,200	10,150
KFC	5,488	5,910	6,534	6,925
Pizza Hut	2,195	2,240	2,281	2,277
Others	300	334	385	948
% of total restaurant counts				
KFC	68.7	69.7	71.0	68.2
Pizza Hut	27.5	26.4	24.8	22.4
Others	3.8	3.9	4.2	9.3

Note: Others include Taco Bell, Little Sheep, Huang Ji Huang, East Dawning, COFFii & JOY and Lavazza

Source(s): The Group, ABCI Securities

The Group's restaurants are either company-owned or operated by franchise. In 9M20, the revenue of company-owned restaurants, represented by company sales, contributed to 89.2% of total revenue. We believe the Group's high percentage of company sales enables it to implement its strategies more efficiently.

FY ended Dec 31	FY17	FY18	FY19	9M20
Company sales	90.0	90.7	90.3	89.2
Franchise fees and income	1.8	1.7	1.7	1.9
Revenues from transactions with franchisees and unconsolidated affiliates	7.7	7.2	7.5	8.1
Other revenues	0.5	0.5	0.6	0.8

Source(s): The Group, ABCI Securities

The Group is the largest restaurant company in China in terms of 2019 system sales, which includes sales generated from company-owned, franchise, and unconsolidated affiliate restaurants. In 2019, the Group's total system sales reached RMB 67.6bn, ranking first among players in China's catering service market in 2019 with a 1.4% of market share.

The Group was also the top player in both the QSR (quick service restaurant) and CDR (casual dining restaurant) markets in China in 2019. KFC brand was the largest brand in China's QSR market in 2019 with system sales of RMB 52.2bn and a market share of 4.9%. In China's CDR market, the Pizza Hut and Huang Ji Huang brand were ranked first and second with market shares of 2.7% and 0.5% in 2019.

Exhibit 6: Top 5 players in China's catering service market, 2019

Ranking	Company	Company Description	System Sales (RMB bn)	Market Share (%)	Number of Restaurants by year end
1	YUMC	The Group	67.6	1.4	9,200
2	Company A	A multinational QSR brand that entered China in the 1990s, mainly focused on burgers.	29.0	0.6	~3,300
3	Company B	A domestic Chinese cuisine brand established in 1994, mainly focused on hot pot.	23.4	0.5	~700
4	Company C	A multinational chain coffee brand that entered China in the late 1990s, mainly focused on coffee	20.3	0.4	~4,300
5	Company D	A domestic QSR brand in China established in 2003, mainly focused on burgers	10.7	0.2	~2,600

Note: System sales reflect results of all restaurants regardless of ownership, including Company-owned, franchise and unconsolidated affiliate restaurants that operate the Group's restaurant concepts, except for non-Company-owned restaurants for which the Group do not receive a sales-based royalty

Source(s): F&S, ABCI Securities

Exhibit 7: Top 10 players in China's QSR market, 2019

Ranking	Company	Company Description	System Sales (RMB bn)	Market Share (%)	Number of Restaurants by year end	Cuisine Type
1	YUMC (KFC)	The Group	52.2	4.9	6,534	Western
2	Company A	A multinational brand that entered China in the 1990s, mainly focused on burgers.	29.0	2.7	~3,300	Western
3	Company D	A domestic brand established in 2003, mainly focused on burgers	10.7	1.0	~2,600	Western
4	Company E	A domestic brand established in 2000, mainly focused on burgers.	9.9	0.9	~10,000	Western
5	Company F	A multinational brand that entered China in 2005, mainly focused on burgers	5.4	0.5	~1,300	Western
6	Company G	A domestic brand established in 2003, mainly focused on chicken soup	3.4	0.3	~700	Chinese
7	Company H	A domestic brand established in 1990, mainly focused on steamed dishes	3.2	0.3	~700	Chinese
8	Company I	A domestic brand established in 1995, mainly focused on Chinese breakfast dishes	2.6	0.2	~400	Chinese
9	Company J	A multinational brand that entered China in 1992, mainly focused on Japanese rice bowls.	2.5	0.2	~600	Others
10	Company K	A multinational brand that entered China in 1996, mainly focused on Japanese ramen	2.3	0.2	~800	Others

Note: System sales reflect results of all restaurants regardless of ownership, including Company-owned, franchise and unconsolidated affiliate restaurants that operate the Group's restaurant concepts, except for non-Company-owned restaurants for which the Group do not receive a sales-based royalty

Source(s): F&S, ABCI Securities

Exhibit 8: Top 10 players in China's CDR market, 2019

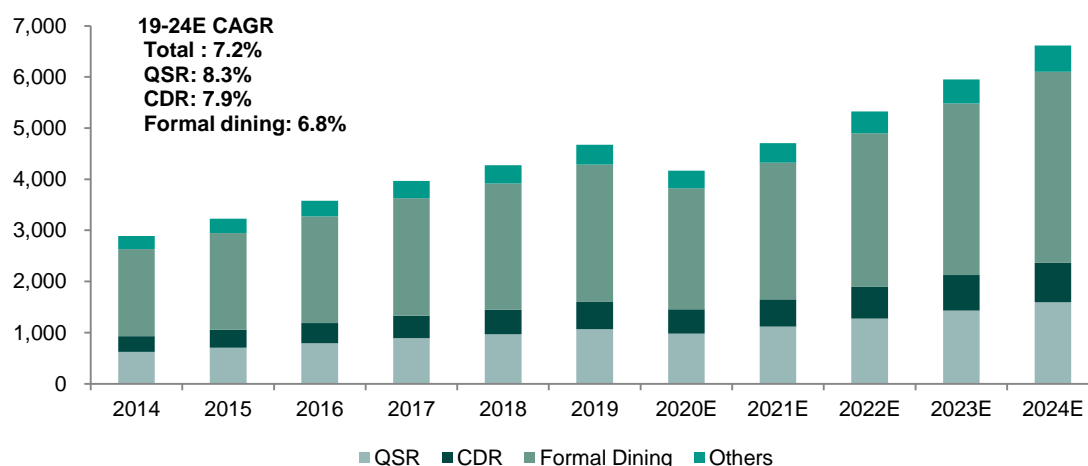
Ranking	Company	Company Description	System Sales (RMB bn)	Market Share (%)	Number of Restaurants by year end	Cuisine Type
1	YUMC (Pizza Hut)	The Group	14.5	2.7	2,281	Western
2	YUMC (Huang Ji Huang)	The Group	2.5	0.5	~640	Chinese
3	Company M	A domestic brand established in 1993, mainly focused on steak	1.7	0.3	~380	Western
4	Company N	A multinational brand that entered China in 2003, mainly focused on Italian cuisine	1.5	0.3	~330	Western
5	Company O	A domestic brand established in 1998, mainly focused on dim sum	1.1	0.2	~110	Chinese
6	Company P	A multinational brand that entered China in 2003, mainly focused on pizza.	0.8	0.2	~220	Western
7	Company Q	A multinational brand that entered China in 2006, mainly focused on pizza.	0.8	0.1	~60	Western
8	Company R	A domestic brand established in 1999, mainly focused on salads and sandwiches.	0.7	0.1	~120	Others
9	Company S	A domestic brand established in 1993, mainly focused on steak.	0.7	0.1	~170	Western
10	Company T	A multinational brand that entered China in 1997, mainly focused on pizza	0.7	0.1	~270	Western

Note: System sales reflect results of all restaurants regardless of ownership, including Company-owned, franchise and unconsolidated affiliate restaurants that operate the Group's restaurant concepts, except for non-Company-owned restaurants for which the Group do not receive a sales-based royalty

Source(s): F&S, ABCI Securities

2. Industry provides room for growth

The industry presents room for growth. According to F&S, the total market size (in terms of revenue) of the restaurant market in China is expected to grow at a CAGR of 7.2% in 2019-24E; the total market size (in terms of revenue) of the QSR and CDR markets in China are expected to grow at CAGRs of 8.3% and 7.9% in 2019-24E, higher than growth in the overall market.

Exhibit 9: Restaurant market size in China (in terms of revenue, RMB bn)


Source(s): F&S, ABCI Securities

3. Expansion plan sets the path for long-term growth

There are several dimensions of the Group's growth strategy, including restaurant network expansion, improving unit-level performance, and developing new sources of revenue, investment in technology with focuses on digital and delivery capabilities, restaurant portfolio expansion, and investment in high-quality assets. The Group currently sets the target to growth the number of restaurants to 20,000, or over two times the restaurant count as of end-FY19 in the future.

Exhibit 10: Growth strategies by the Group

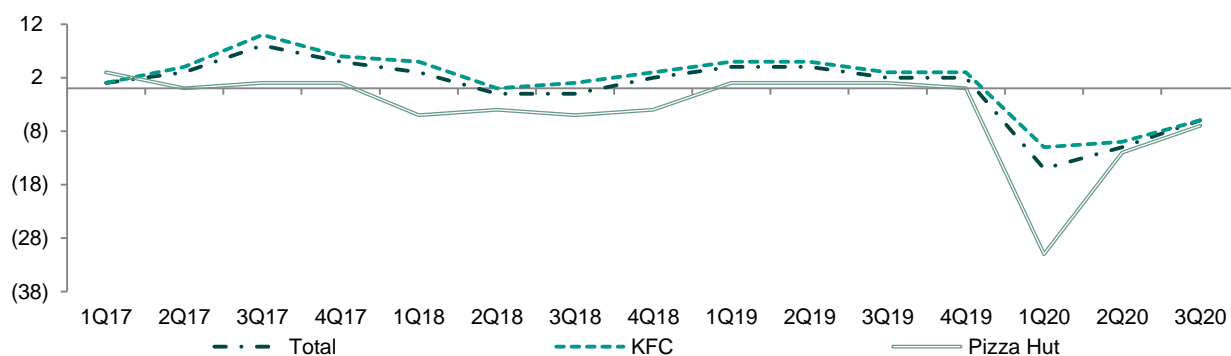
Strategy	Measures
Restaurant network expansion	➤ Target to grow the number of restaurants to 20,000, or over two times the restaurant count as of end-2019 in the future; the Group currently tracking over 800 cities that do not have a KFC or Pizza Hut restaurant
	➤ Explore various new restaurant formats to support further expansion, including different store designs or service models aimed at addressing the needs of different guests and for different occasions, such as drive-thru restaurants and less capital-intensive models
	➤ Seek franchise opportunities for both core and emerging brands
	➤ Focus on exploring suitable business models to achieve sustainable growth for emerging brands; product innovation and operational enhancement for emerging brands to potentially scale-up operations in the future
Improving unit-level performance and developing new sources of revenue	➤ Food innovation and value proposition: Develop unique recipes and special seasonings to provide appealing, tasty and convenient food choices at competitive prices; KFC plans to continue focusing on value with product offerings such as the bucket and increased combo options throughout the day; Pizza Hut plans to continue its multiple value campaigns
	➤ Daypart opportunities: significant daypart opportunities across brands
	➤ Best in-store experience: plan to continue to invest in refurbishing restaurants; portfolio brands also look to improve efficiency to drive sales growth
Investment in technology with focus on digital and delivery capabilities	➤ Digital: continue to leverage powerful digital ecosystem to drive sales, improve the guest experience and increase operational efficiency; increase investment in end-to-end digitalization, automation and AI, to more effectively connect online traffic with offline assets
	➤ Delivery: optimize delivery service by adopting innovative technologies, rolling out new delivery menu items and developing novel delivery service concepts, such as rainy-day delivery menu of the Group
Restaurant portfolio expansion	➤ Aim to maintain industry leading position in the QSR and CDR markets in China with core brands and gain a stronger foothold and enhanced know-how in the Chinese cuisine space, which represents a significant share of the restaurant industry in China
	➤ Currently building a coffee portfolio to capture today's underserved coffee market in China across different customer segments, including K-Coffee which offers convenience and value, balanced by newly incubated concept COFFii & JOY which offers an artisanal coffee experience
Prudently pursue investment in high-quality assets	➤ Investment strategy primarily focuses on two areas, brands, and enablers that empower brands (e.g. ecosystem, technology)
	➤ Continue to identify and evaluate investment opportunities in high-quality brands to capture growth opportunities
	➤ Look for potential opportunities for enabler investments, build strategic moat and further enhance competitiveness

Source(s): The Group, ABCI Securities

4. Strong operating track record

In FY16-19, the Group has achieved an average SSSG (same-store sales growth, excluding the impact of foreign currency translation) of 3%; the average SSSG for KFC was 4%. The pandemic affected business in 1Q20 but recovery was seen in 2Q20 and 3Q20. In 3Q20, the overall SSSG climbed to -6% YoY, while the SSSG of KFC and Pizza Hut were -6% YoY and -7% YoY.

Exhibit 11: Quarterly SSSG (YoY %)

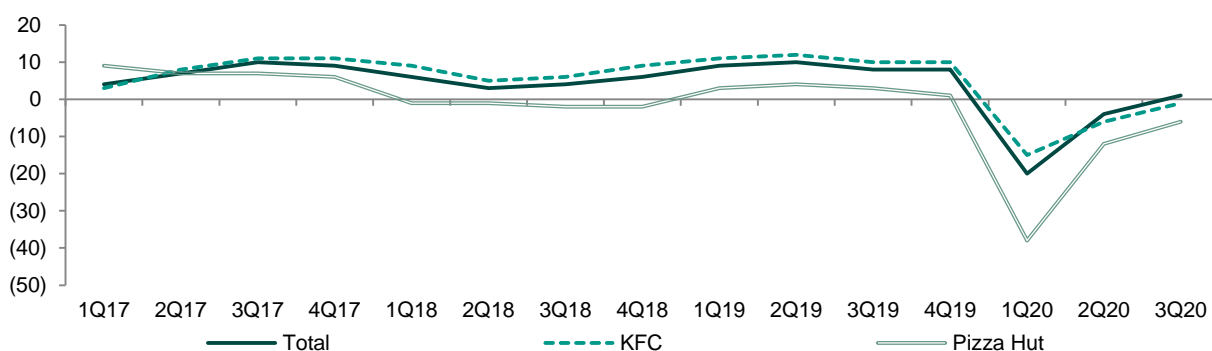


Note: 1) Same-store sales growth (SSSG) is the estimated percentage change in sales of food of all restaurants in the Company system that have been open prior to the first day of our prior fiscal year, excluding the period during which stores are temporarily closed; 2) figures exclude impact of foreign currency translation

Source(s): The Group, ABCI Securities

On the other hand, the Group's system sales, which reflects results of all restaurants regardless of ownership (except for sales from non-Company-owned restaurants), also has been recovering in terms of growth on constant currency basis. The overall system sales growth in 3Q20 has already recovered to 1% YoY compared to -20% YoY in 1Q20; while the system sales growth of KFC and Pizza Hut increased from -15% YoY and -38% YoY in 1Q20 to -1% YoY and -6% YoY.

Exhibit 12: System sales growth (YoY %)



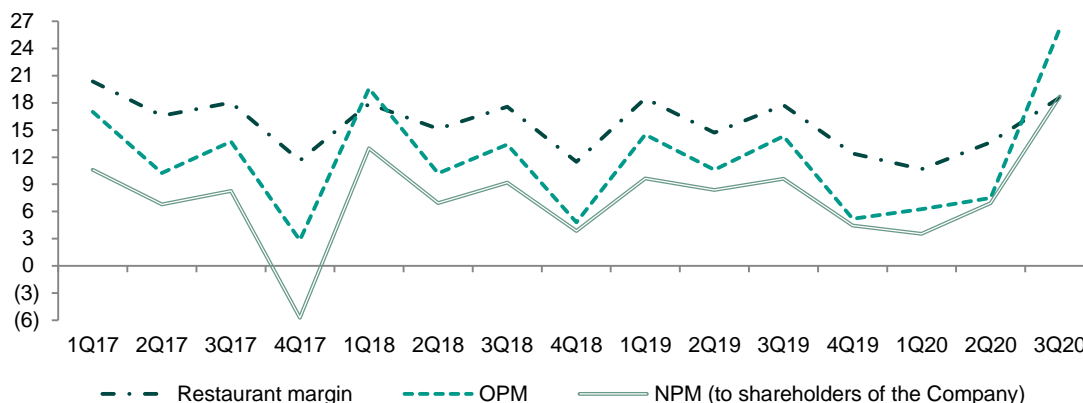
Note: 1) system sales refers to the results of all restaurants regardless of ownership, including Company-owned, franchise and unconsolidated affiliate restaurants that operate our concepts, except for sales from non-Company-owned restaurants, for which the Group does not receive a sales-based royalty; 2) figures exclude impact of foreign currency translation

Source(s): The Group, ABCI Securities

Margins were also affected by the COVID-19 pandemic, and have gradually increased after dropping in 1Q20. In 3Q20, restaurant margin and NPM (to shareholders of the Company) reached 26.2% and 18.6%, which both exceeded their previous levels in FY17-19. In addition, it is worth noting that despite the rise of chicken and pork price in 2019, the Group's margins were relatively stable in comparison. We believe the Group's flexibility in product offerings in its portfolio restaurants help mitigate the rise in raw material price and help push its margins to new levels in 2020.

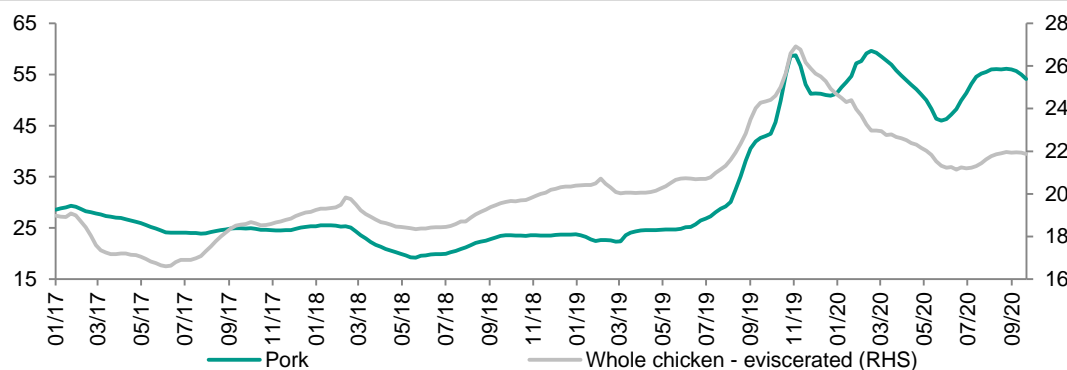


Exhibit 13: Quarterly margins (%)



Note: 1) restaurant margin is defined as restaurant profit divided by company sales; 2) restaurant profit is defined as company sales less expenses incurred directly by company-owned restaurants in generating company sales; 3) company sales refers to revenues from Company-owned restaurants
Source(s): The Group, ABCI Securities

Exhibit 14: Average weekly wholesale price of pork and chicken in China (RMB/kg)



Source(s): MOA, ABCI Securities

Moreover, we believe the Group's strategy digital development and channel development enabled the quick recovery post pandemic. In 3Q20, The Groups KFC and Pizza Hut brands had a combined member count of over 285mn, which represents growth of 23.9% YoY. In 3Q20, digital orders of these two brands represented ~78% of company sales vs. ~56% in 3Q19; delivery as a percentage of company sales increased by 8ppt YoY to ~28%.

Exhibit 15: Digital and delivery (KFC and Pizza Hut)

	3Q19	3Q20
Member count (as of quarter-end)	230mn+	285mn+
Member sales as % of system sales	~53%	~60%
Delivery as % of company sales	~20%	~28%
Digital orders as % of company sales	~56%	~78%

Source(s): The Group, ABCI Securities

5. Prudent financial management

Working capital management has been efficient. In FY17-19, the receivable turnover days was 3.5, reflecting a strong cash collection capability; inventory turnover days was ~40 and payable turnover days was ~44. The overall cash conversion cycle (CCC) averaged at -0.5 day in FY17-19.

Exhibit 16: Working capital turnover days of the Group

FY ended Dec 31	FY17	FY18	FY19
Receivable	3.6	3.5	3.5
Inventory	40.8	38.9	41.5
Payable	42.3	45.1	45.8
CCC	2.1	(2.7)	(0.8)

Note:

1) Inventory turnover days for each period equals the average of the beginning and ending balances of net inventory (including inventory procured by the Company, which is subsequently supplied to stores of unconsolidated affiliates and franchisees) for that period divided by total cost of food and paper for Company-owned stores and stores of unconsolidated affiliates and franchisees for that period, and multiplied by the number of days in that period

2) Receivable turnover days for each period equals the average of the beginning and ending balances of net accounts receivable for that period divided by total revenues for that period, and multiplied by the number of days in that period

3) Payable turnover days for each period equals the average of the beginning and ending balances of accounts payable related to inventory purchase and distribution for that period divided by total cost of food and paper for Company-owned stores and stores of unconsolidated affiliates and franchisees for that period and, multiplied by the number of days in that period

Source(s): The Group, ABCI Securities

The Group also had no debts as of end-Sep 2020 and was debt-free in FY17-19. As of end-Sep 2020, the Group's net cash position reached US\$ 1,782mn. The successful HK listing boosts its cash position further, reducing the need for additional financing.

The strong cash position enables the Group to maintain a consistent dividend payout prior to the COVID-19 outbreak. In FY19, the Group's quarterly cash DPS was maintained at US\$ 0.12. Due to the pandemic's disruption to its operation, the Group suspended cash dividend payment for the first two quarters in 2020. However, the Group has announced a cash dividend of US\$ 0.12 for 3Q20.

Exhibit 17: Historical cash DPS of the Group (US\$)

FY ended Dec 31	1Q	2Q	3Q	4Q
FY20	0	0	0.12	Not yet announced
FY19	0.12	0.12	0.12	0.12
FY18	0.1	0.1	0.1	0.12

Source(s): The Group, ABCI Securities

Growth and profitability outlook

Revenue CAGR of 7.2% in FY19-22E

We expect the Group's revenue growth to expand at 7.2% CAGR in FY19-22E, mainly supported by the expansion of its restaurant network and optimization of its product offerings. We assume KFC and Pizza Hut would remain the major sources of revenue, with a combined revenue contribution of 89.3% in FY22E. We project the revenue CAGRs of KFC and Pizza Hut to be 8.0% and 0.2%. Revenue growth is expected to resume after the FY20E, which was negatively impacted by the COVID-19 outbreak.

Exhibit 18: Revenue projection					
FY ended Dec 31	FY18A	FY19A	FY20E	FY21E	FY22E
Revenue (US\$ mn)					
Total	8,415	8,776	8,159	9,495	10,822
KFC	5,688	6,040	5,644	6,636	7,602
Pizza Hut	2,111	2,054	1,858	1,965	2,064
Growth (YoY %)					
Total	8.3	4.3	(7.0)	16.4	14.0
KFC	12.3	6.2	(6.6)	17.6	14.6
Pizza Hut	0.9	(2.7)	(9.5)	5.8	5.0

Source(s): The Group, ABCI Securities estimates

Margins will continue to improve

We expect the Group's margins to improve on scale expansion and higher efficiency. We expect restaurant margin, operating margin and NPM (to shareholders of the Company) to increase from 16.0%, 11.4%, and 8.1% in FY19 to 17.9%, 12.9% and 9.9% in FY22E; restaurant margin of KFC and Pizza Hut would increase to 18.3% and 13.2% in FY22E. In addition, non-GAAP OPM and non-GAAP NPM (to shareholders of the Company) are expected to increase to 12.7% and 10.3% in FY22E.

Exhibit 19: Margin projections (%)					
FY ended Dec 31	FY18A	FY19A	FY20E	FY21E	FY22E
Restaurant margin	15.7	16.0	15.6	16.7	17.9
- KFC	17.9	17.8	17.5	18.0	18.3
- Pizza Hut	10.2	11.1	11.0	12.1	13.2
OPM	12.3	11.4	10.2	11.5	12.9
- KFC	16.3	16.2	15.9	16.4	16.7
- Pizza Hut	4.6	5.6	5.2	6.4	7.6
NPM (to shareholders of the Company)	8.4	8.1	7.9	8.8	9.9
Non-GAAP OPM	10.2	10.4	9.9	11.1	12.7
Non-GAAP NPM (to shareholders of the Company)	7.2	8.3	8.7	8.7	10.3

Note: 1) Non-GAAP measures exclude the impact of share-based compensation expenses on operating costs and expenses; 2) Restaurant margin is defined as restaurant profit divided by company sales; 3) Restaurant profit is defined as company sales less expenses incurred directly by company-owned restaurants in generating company sales; 4) Company sales refers to revenues from Company-owned restaurants

Source(s): The Group, ABCI Securities estimates

Valuation

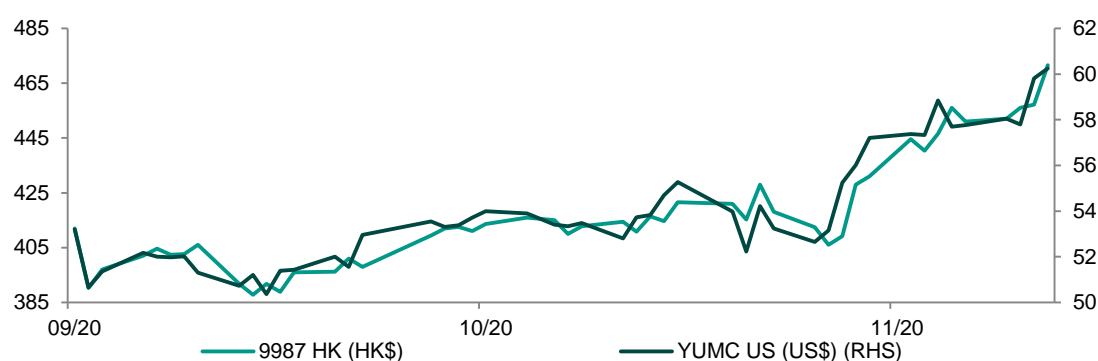
TP at US\$ 71.8/HK\$ 556.8; initiate with BUY

For valuation, we apply the DCF approach with the following assumptions: 1) a beta of 0.77; 2) a risk-free rate of 3.18%; 3) an expected market return of 10.71%; 4) a target debt/asset ratio of 0.0%; 5) a terminal growth rate of 3%; 6) based on 1-5, a WACC of 9.0%.

Our DCF model yields a TP at US\$ 71.8/HK\$ 556.8, which represents 46.63x/36.16x 20E/21E P/E, or 5.04x/4.57x 20E/21E P/B. Initiate with **BUY**.

Its HK share price has been closely tracking the US equivalent. The consistency means that the price/valuation gap, if any, is limited.

Exhibit 20: HK&US stock price comparison (as of Nov 19, 2020)



Source(s): Bloomberg, ABCI Securities

Peer valuation analysis

As of Nov 19, 2020, the Group's comparable peers are trading at an average of 183.38x 20E P/E or 29.99x 20E EV/EBITDA, which was higher than the Group's current valuation. We apply the EV/EBITDA ratio for comparison since a number of comparable US peers do not have positive equity as a result of share repurchase; as such, comparison of the P/B ratio would not be appropriate. In addition, the Group's two HK-listed peers' high 20E P/E caused the average 20E P/E to skew upward.

Exhibit 21: Peer valuation comparison

Ticker	Name	P/E (x)		EV/EBITDA (x)		Yield (%)		ROAA (%)		ROAE (%)	
		2020	2021	2020	2021	2020	2021	2020	2021	2020	2021
MCD US	McDonald	34.62	25.75	21.60	17.23	2.3	2.5	9.9	12.3	(53.6)	(74.6)
CMG US	Chipotle	119.58	61.44	60.42	33.86	0.0	0.0	5.1	10.1	16.5	28.3
YUM US	YUM!	30.91	26.50	22.73	19.65	1.8	2.0	22.5	19.0	(10.2)	(16.6)
QSR US	Restaurant Brands	27.41	21.46	21.49	17.86	3.5	3.6	6.7	5.4	25.6	35.5
DPZ US	Domino's Pizza	30.92	29.64	23.86	22.13	0.8	0.9	34.5	30.0	(4.2)	(1.8)
WEN US	Wendy's	39.41	31.76	16.59	15.29	1.2	1.6	3.4	3.1	24.4	29.3
PZZA US	Papa John's	54.15	35.03	20.13	16.51	1.1	1.1	9.4	10.2	(3.4)	105.5
6862 HK	Haidilao	252.82	55.09	64.46	25.54	0.2	0.5	5.2	19.1	9.6	31.3
520 HK	Xiabuxiabu	1,060.57	29.27	18.64	9.06	0.3	1.1	0.5	8.6	1.2	19.5
Average of peers		183.38	35.10	29.99	19.68	1.3	1.5	10.8	13.1	0.7	17.4
YUMC US YUM! China		39.12	30.33	14.15	11.77	0.40	0.80	7.6	7.8	14.3	13.3

Note: Data as of Nov 19, 2020

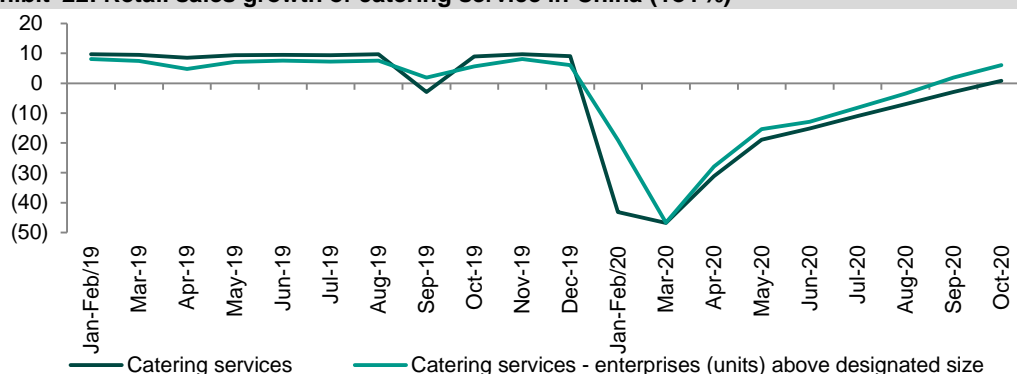
Source(s): Bloomberg, ABCI Securities estimate

Risk factors

Macroeconomic risk

China's economy continues to recover from the COVID-19 pandemic. However, consumers show reservation in restaurant dining in post-pandemic era. According to the NBS, growth rates of retail sales of "catering services" and "catering services of enterprises (units) above designated size" reached 0.8% YoY and 6.1% YoY in Oct 2020, which is the first time since Jan 2020 that both of the growth rates turning positive. Meanwhile, the national retail sales growth recovery was slightly better and turned positive in Aug 2020. If post-pandemic recovery is disrupted, the per capita income growth may decline and people may cut back on consumption.

Exhibit 22: Retail sales growth of catering service in China (YoY%)



Source(s): NBS, ABCI Securities

Regulatory risk

In Oct 2019, the State Council amended the Regulation for the Implementation of the Food Safety Law (the "Regulation of Food Safety Law"). The Regulation of Food Safety Law outlines detailed rules for food safety assessment, food safety standards, food production and food business, food inspection and other matters. Certain violations may result in severe administrative and criminal penalties imposed on the Company, as well as its legal representatives, senior management members, and other employees. There remain uncertainties with respect to the interpretation and enforcement of the newly amended law.

Operational risk

Incidents of foodborne illnesses, such as E. coli, hepatitis A and salmonella, have occurred and may reoccur in the Group's restaurants. Food safety issues, such as food tampering, contamination, and adulteration, can result in food poisoning and tarnish the restaurant reputation.

Cost risk

Supply disruption can drive up raw material costs and suppress margins. In the long term, the Group may face higher raw material costs induced by inflation. The sensitivity analysis of food and paper cost on net profit is shown below.

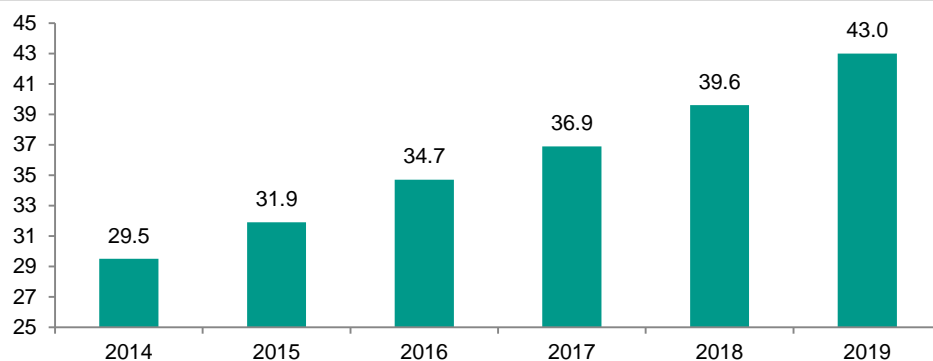
Exhibit 23: Sensitivity analysis of food and paper cost sensitivity on net profit (2019)

Food and paper costs change (%)	(10)	(5)	(2)	(1)	1	2	5	10
Food and paper costs (US\$ mn)	2,231	2,355	2,429	2,454	2,504	2,529	2,603	2,727
Changes in food and paper costs (US\$ mn)	(248)	(124)	(50)	(25)	25	50	124	248
Changes in net income (US\$ mn)	186	93	37	19	(19)	(37)	(93)	(186)

Source(s): The Group, ABCI Securities

In addition, the industry average salary cost has been increasing. Average annual salary of employees in the restaurant industry in China has been trending up at 7.8% CAGR in 2014-19 and reached RMB 43.0k per year. As the living standard continues to rise in China, it is likely the Group would face higher employee salary in the future.

Exhibit 24: Average annual salary of employees in China's restaurant industry (RMB k)



Source(s): NBS, F&S report, ABCI Securities

Concentration risk

The Group derives a majority of revenue from the KFC and Pizza Hut brands, which jointly contributed to 91.3% of total revenue in 9M20. To diversify risk, the Group would need to cultivate other revenue contributors or declined performance of the two above brands would have negative impacts on the Group's financials.

Seasonality risk

According to the Group, it typically experiences higher sales during the Chinese festivities, holiday seasons, and summer months; sales and operating profit are generally lower in 2Q and 4Q. The fluctuation of sales performance in different quarters may not correspond to proportional changes in operating expenses, which can lead to fluctuation in margins.

Non-GAAP financial metrics

The Group also discloses non-GAAP financial measures that exclude the impact of share-based compensation expenses on operating costs and expenses. There are discrepancies between the reported figures and the non-GAAP figures, and investors should exercise caution when interpreting the non-GAAP data.

EPS dilution

The new share issue in the HK listing would lead to increase of number of shares. This would create a temporary effect of EPS dilution.

Financial statements

Consolidated income statement

FY ended Dec 31 (US\$ mn, except per share data)	FY18A	FY19A	FY20E	FY21E	FY22E
Revenue	8,415	8,776	8,159	9,495	10,822
Costs and expenses, net	(7,474)	(7,875)	(7,331)	(8,404)	(9,424)
Restaurant profit	1,199	1,266	1,142	1,407	1,711
General and administrative expenses	(456)	(487)	(459)	(561)	(666)
Franchise expenses	(71)	(71)	(72)	(82)	(92)
Expenses for transactions with franchisees and unconsolidated affiliates	(595)	(645)	(639)	(754)	(853)
Other operating costs and expenses	(29)	(37)	(32)	(44)	(57)
Closures and impairment expenses, net	(41)	(36)	(45)	(52)	(56)
Other income, net	152	60	83	112	148
Operating profit	941	901	828	1,091	1,398
Others	9	102	55	65	94
Pretax profit	950	1,003	883	1,157	1,492
Tax	(214)	(260)	(214)	(290)	(368)
Net profit	736	743	669	867	1,124
- Owners	708	713	645	832	1,076
- MI	28	30	24	34	48
Cash Dividend	161	181	101	201	201
EPS (US\$)					
- Basic	1.84	1.89	1.54	1.99	2.57
- Diluted	1.79	1.84	1.50	1.94	2.50
Cash DPS (US\$)	0.44	0.48	0.24	0.48	0.48

Source(s): The Group, ABCI Securities estimates

Consolidated balance sheet

FY ended Dec 31 (US\$ mn)	FY18A	FY19A	FY20E	FY21E	FY22E
Cash and cash equivalents	1,266	1,046	1,502	1,413	2,361
Accounts receivable	80	88	69	112	95
Inventories	307	380	228	475	323
Others	299	745	2,813	2,933	3,000
Current assets	1,952	2,259	4,612	4,933	5,778
PP&E	1,615	1,594	1,723	1,862	2,084
Operating lease right-of-use assets	0	1,985	2,240	2,420	2,710
Intangible assets & goodwill	382	348	1,063	1,103	1,149
Others	661	764	933	1,235	1,365
Non-current assets	2,658	4,691	5,959	6,621	7,308
Total assets	4,610	6,950	10,571	11,554	13,086
Accounts payable and other current liabilities	1,199	1,691	2,175	2,334	2,679
Income taxes payable	54	45	42	72	75
Current liabilities	1,253	1,736	2,217	2,406	2,755
Non-current operating lease liabilities	0	1,803	1,913	2,085	2,376
Non-current finance lease obligations	25	26	26	26	26
Others	355	210	318	294	274
Non-current liabilities	380	2,039	2,257	2,405	2,676
Shareholders' capital	2,873	3,077	5,975	6,586	7,451
MI	103	98	122	156	205
Total equity	2,976	3,175	6,097	6,742	7,655
Total liabilities and equity	4,610	6,950	10,571	11,554	13,086

Source(s): The Group, ABCI Securities estimates

Consolidated cash flow statement

FY ended Dec 31 (US\$ mn)	FY18A	FY19A	FY20E	FY21E	FY22E
Net profit	736	743	669	867	1,124
Depreciation and amortization	445	767	852	927	1,012
Change in working capital	196	82	642	(171)	531
Others	(44)	(407)	(10)	18	(17)
Cash flow from operating activities	1,333	1,185	2,153	1,641	2,650
Capital spending	(470)	(435)	(520)	(634)	(638)
Others	(82)	(475)	(2,282)	(70)	(72)
Cash flow from investing activities	(552)	(910)	(2,802)	(704)	(710)
Share issuance - HK	0	0	2,194	0	0
Cash dividend	(161)	(181)	(101)	(201)	(201)
Others	(357)	(299)	(980)	(832)	(766)
Cash flow from financing activities	(518)	(480)	1,113	(1,033)	(967)
Effect of foreign exchange rate changes	(56)	(6)	(9)	8	(25)
Net change in cash, cash equivalent, and restricted cash	207	(211)	456	(89)	948
cash, cash equivalent, and restricted cash - end	1,266	1,055	1,511	1,422	2,370

Source(s): The Group, ABCI Securities estimates

Key operating and financial ratios

FY ended Dec 31	FY18A	FY19A	FY20E	FY21E	FY22E
Growth (YoY %)					
Net revenue	8.3	4.3	(7.0)	16.4	14.0
Restaurant profit	2.4	5.6	(9.8)	23.2	21.6
Operating profit	21.0	(4.3)	(8.1)	31.8	28.1
Net profit (to shareholders of the Company)	77.9	0.7	(9.5)	28.9	29.3
Non-GAAP operating profit	10.3	6.7	(11.7)	30.7	30.6
Non-GAAP net profit	8.4	20.3	(3.1)	16.8	35.2
Profitability ratios (%)					
Restaurant margin	15.7	16.0	15.6	16.7	17.9
OPM	12.3	11.4	10.2	11.5	12.9
NPM (to shareholders of the Company)	8.4	8.1	7.9	8.8	9.9
Non-GAAP OPM	10.2	10.4	9.9	11.1	12.7
Non-GAAP NPM	7.2	8.3	8.7	8.7	10.3
Return ratios (%)					
ROAA	16.5	12.9	7.6	7.8	9.1
ROAE	25.1	24.0	14.3	13.3	15.3
Liquidity ratio (x)					
Current ratio	1.6	1.3	2.1	2.1	2.1
Quick ratio	1.3	1.1	2.0	1.9	2.0
Cash ratio	1.0	0.6	0.7	0.6	0.9
Working capital (days)					
Receivable turnover	3.5	3.5	3.5	3.5	3.5
Inventory turnover	38.9	41.5	40.5	40.9	41.3
Payable turnover	45.1	45.8	46.0	46.7	46.2
CCC	(2.7)	(0.8)	(2.0)	(2.3)	(1.5)
Leverage ratios (%)					
Total debt to Equity	0.0	0.0	0.0	0.0	0.0
Total debt to Total assets	0.0	0.0	0.0	0.0	0.0
Net debt/(cash) to Equity	(42.5)	(32.9)	(24.6)	(21.0)	(30.8)
Net debt/(cash) to Total assets	(27.5)	(15.1)	(14.2)	(12.2)	(18.0)

Note: 1) Restaurant profit is defined as company sales less expenses incurred directly by company-owned restaurants in generating company sales; 2) Restaurant margin is defined as restaurant profit divided by company sales; 3) Company sales refers to revenues from Company-owned restaurants; 4) Non-GAAP measures exclude the impact of share-based compensation expenses on operating costs and expenses; 5) Receivable turnover days equals the average of the beginning and ending balances of net accounts receivable for that FY divided by total revenues for that FY, and multiplied by the number of days; 6) Inventory turnover days equals the average of the beginning and ending balances of net inventory (including inventory procured by the Company, which is subsequently supplied to stores of unconsolidated affiliates and franchisees) for that FY divided by total cost of food and paper for Company-owned stores and stores of unconsolidated affiliates and franchisees for that FY, and multiplied by the number of days; 7) Payable turnover days equals the average of the beginning and ending balances of accounts payable related to inventory purchase and distribution for that FY divided by total cost of food and paper for Company-owned stores and stores of unconsolidated affiliates and franchisees for that FY and, multiplied by the number of day

Source(s): The Group, ABCI Securities estimates

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Rating	Definition
Buy	Stock return \geq Market return rate (10%)
Hold	- Market return (-10%) \leq Stock return < Market return rate (10%)
Sell	Stock return < - Market return (-10%)

Stock return rate: expected percentage change of share price plus gross dividend yield over the next 12 months

Market return rate: average market return rate since 2008 (HSI total return index 2008-19 CAGR at 10%)

Time horizon of share price target: 12-month

Stock rating, however, may vary from the stated framework due to factors including but not limited to: corporate governance, market capitalization, historical price volatility relative to corresponding benchmark index, average daily turnover of the stock relative to market capitalization of the stock, competitive advantages in corresponding industry, etc.

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