

Spin-Off Update

Yum China (YUMC) Registers Robust Earnings Growth in 4Q16

Yum China Holdings, Inc.

Parent: Yum! Brands, Inc. (NYSE: YUM)

Sector: Restaurants

Spin-Off: Yum China Holdings, Inc. (NYSE: YUMC)

Sector: Restaurants

Target Price: \$35.00

Share Price: \$28.10*

Share Outstanding: 383 million*

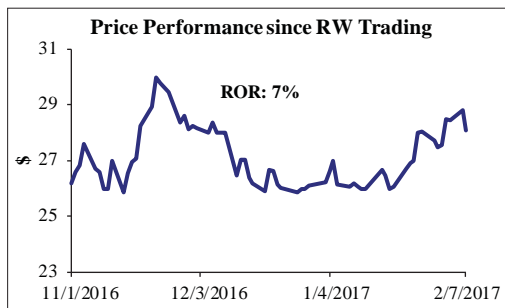
Market Capitalization: \$10.8 billion*

Recommendation: Buy

Upside: 25%

*As of February 7, 2017

Price Performance



Source: Bloomberg

Split-Off Details

Announcement	October 20, 2015
Initial Form-10 Filing	May 4, 2016
Latest Form-10 Filing	November 1, 2016
When-Issued Trading	October 17, 2016
Record Date	October 19, 2016
Distribution Date	October 31, 2016
Regular-Way Trading	November 1, 2016
Spin-Off Ratio	1:1
Tax-Status	Tax-Free
Index Impact	None

On February 7, 2017, Yum China Holdings, Inc. (NYSE: YUMC, \$28.10, Market Capitalization: \$10.8 billion) declared 4Q16 results. Total revenue decreased 3% YOY to ~\$2 billion, 3.7% lower than street estimates. Total system sales increased by 4%, including growth of 4% at KFC and 6% at Pizza Hut Casual Dining which was excluding FX. Adjusted EBITDA increased 14% YOY to \$232 million, implying margin expansion of 182 bps to 11.7%. YUMC reported net income of \$88 million or \$0.23 earnings per share, on diluted basis, compared to net loss of \$29 million reported in 4Q15.

The company expects to add 550 to 600 new stores in 2017. Additionally, YUMC expects its Capex to be in the range of \$400 to \$500 million during 2017. The company anticipates double digit growth in its operating profit along with margin expansion, excluding FX, strong cash flow and enhanced balance sheet position. The Board of Directors has approved shares repurchase program worth \$300 million.

On October 31, 2016, Yum! Brands, Inc. completed the tax-free spin-off of Yum China Holdings, Inc. The spin-off ratio was 1:1, implying that each YUM shareholder received 1 share of YUMC for every share of YUM common stock held as of the record date October 19, 2016. On November 1, 2016, Yum China Holdings, Inc. started regular-way trading on the NYSE under the ticker YUMC.

We reiterate our target price for Yum China Holdings, Inc. of \$35.00 per share, implying a 25% upside from the current market price of \$28.10 per share. We retain our Buy rating on the stock, given margin improvement and strong cash flow prospects.

Key Highlights of the Conference Call

2017 Outlook

Yum China expects to add 550 to 600 new stores in 2017. It expects Capex to be in the range of \$400 to \$500 million. The company anticipates that operating profit will grow at double digit with margin expansion, excluding FX. It forecasts strong free cash flow and enhanced balance sheet position for the year. YUMC expects robust growth ahead from Digital and Delivery which will drive system sales and same store sales growth.

Share Repurchase

Recently, the Board of Directors approved repurchase of up to \$300 million shares of common stock. These shares may be repurchased from time to time in the open market, through privately negotiated transactions or other programs which will be subject to market conditions and other factors.

Recent Development

Yum China opened 575 new restaurants in 2016 of which 302 opened in 4Q16 and 96 of the new restaurants were opened in 56 new cities, driven by KFC brand. The company also remodeled 791 restaurants primarily focused on KFC brand. YUMC launched its first Taco Bell restaurant in Shanghai, China in December 2016.

Key Details - YUMC

Primary Exchange	NYSE
Ticker	YUMC
Price (\$ as of February 7, 2017)	28.10
52 Week Range (\$)	23.79 - 30.37
Shares Outstanding (million)	383
Market Cap (\$ billion)	10.8
Net Cash (\$ billion)	0.9
Enterprise Value (\$ billion)	9.9
Market Float (%)	100
2017 Est. P/E (x)	21.27
Fiscal Year Ending	December 31
Revenue 2016 (\$ billion)	6.8
Index Member	Russell 3000 Index

Top 5 Shareholders - YUMC
Holding %

Primavera Capital Management	4.27
Aberdeen	2.57
BlackRock	2.45
Sun Life Financials Inc	1.81
Fidelity Management	1.81

Overall Results

Total revenue decreased 3% YOY to ~\$2 billion, impacted by slump in the revenues of all segments including KFC, Pizza Hut Casual and Others segment by 4%, 1% and 9% YOY to \$1.3 billion, \$521 million and \$86 million, respectively. However, total system sales increased by 4%, including growth of 4% at KFC and 6% at Pizza Hut Casual Dining which was excluding FX. Operating profit grew almost 11 times to \$58 million compared to 4Q15 owing to lower total costs which declined 6% YOY to \$1.9 billion. However, this was partially offset by unfavorable foreign currency translation impact of \$5 million. Decline in total costs and expenses were primarily attributable to food and paper expense and Occupancy & other operating expenses which declined by 13% and 8% on yearly basis, respectively. Adjusted EBITDA increased 14% YOY to \$232 million, leading to margin expansion by 182 bps to 11.7%. YUMC reported net income of \$88 million or \$0.23 earnings per share, on diluted basis.

\$ million	4Q16	4Q15	% Change
Total revenues	1,978	2,048	(3)%
Operating Profit	58	5	1,060%
Adjusted EBITDA	232	203	14%
Margin	11.7%	9.9%	182 bps
Net Income	88	(29)	403%

Source: Company data

Investment Thesis

We believe Yum China would benefit from its strong presence in Mainland China, wide franchisee mix and focused investment to improve customer experience. We are encouraged by the company's new unit builds and digital acceleration which is expected to enhance customer penetration and boost sales growth. Further, YUMC's successful launch of Taco Bell Store holds potential to propel the sales in future. The company will also benefit from its deep understanding of Chinese consumers and active cost management which is expected to boost the margins. We remain concerned about increased competition owing to online aggregator platform, wage inflation, RMB depreciation and consistent negative trend in same store sales growth (SSSG) for Pizza Hut. Nonetheless, strong cash flow position and well funded capital expenditure will drive the YUMC's future earning and create value for the shareholders.

Valuation

We value Yum China Holdings on a relative valuation basis using EV/EBIT (adjusted for store impairments and other special items) (16.5 x) and P/E (24.0x), both based on our revised 2017 estimates. We value Yum China Holdings below the peers despite its exposure to higher-growth and higher margin market. We believe YUMC's digital CRM programs will drive the system sales & same store sales growth, boosting margins, delivering value to investors in the long-term; however, remain cautious over currency depreciation, costs inflation and rising geopolitical uncertainties.

Yum China Holdings

EV/Adjusted EBIT (x)

\$ million	
2017 Adjusted EBIT	726
Adjusted EBIT Multiple (x)	16.5x
Total EV	11,980
Add: Net Cash	870
Equity Value	12,850

Source: Company data

P/E (x)

\$ million

2017 Net Income	543
Multiple (x)	24.0x
Equity Value	13,029

Source: Company data

\$ million

Average Equity Value	12,939
Shares (million)	369
Target Price(\$)	35.00

Source: Company data

Sensitivity Analysis for YUMC Weighted Average Blended EV/EBIT and P/E multiples

Target Sensitivity		2017E P/E Multiple				
		22.0x	23.0x	24.0x	25.0x	26.0x
2017E EBIT Margin	14.5x	31.50	32.25	33.00	33.75	34.50
	15.5x	32.50	33.25	34.00	34.75	35.50
	16.5x	33.50	34.25	35.00	35.75	36.50
	17.5x	34.50	35.25	36.00	36.75	37.50
	18.5x	35.50	36.25	37.00	37.75	38.50

Company Description

Yum China Holdings, Inc. (YUMC) is a licensee of Yum! Brands in mainland China. It has exclusive rights in mainland China to KFC, China's leading quick-service restaurant brand, Pizza Hut, the leading casual dining restaurant brand in China, and Taco Bell, which opened its first restaurant in China at the end of 2016. Yum China also owns the Little Sheep and East Dawning concepts outright. As of December 2016, Yum China had more than 7,500 restaurants and 420,000 employees in over 1,100 cities.