This post by Jake Rosser has been excerpted from a letter of Coho Capital.

Yum China Holdings is a Chinese quick service restaurant (QSR) operator, which was spun off from Yum Brands in November of 2016. The company's primary brand is KFC with 5,200 units, followed by casual dining concept, Pizza Hut, with 1,700 units. Yum China also has a hot pot chain called Black Sheep with 40 units and a nascent Chinese food focused brand called East Dawning with approximately 14 restaurants. Yum China's smallest brand is Taco Bell, which just opened its first China restaurant in Shanghai. In aggregate, Yum China operates the largest network of chain restaurants in China with over 7,600 restaurants spread across 1,100 cities. Its restaurants see more than two billion customer visits per year.

Despite an attractive growth profile, high returns on capital, and strong brand equity, we were able to acquire shares of Yum China at less than half the price of no moat local competitors. Spin-off dynamics, coupled with investor disdain for all things China, kept investors away resulting in the price misappraisal.

Yum China is three times as large as its next largest competitor, McDonalds. Yum China's size yields significant economies of scale over competitors in sourcing, distribution, real estate, tech investment and advertising. For example, Yum China owns its supply and distribution system with 20 logistics facilities and a fleet of over 500 refrigerated trucks. This provides the company a 1.5% margin advantage against competitors. Further, the company's supply chain enables it to serve tertiary cities that are too expensive for other multinational QSR brands, providing the company an important first mover advantage in markets underserved by fast food outlets.

Despite its advantages, recent operating performance has been uninspiring due to an overhang created by two food safety incidents. The first in 2012, when two of KFC's poultry suppliers were found to be using excessive antibiotics in their chicken, and the second in 2014, when a supplier to KFC was found to have expired meat, even though none of the meat ever made it to KFC. Publicity from the incidents hit same store sales which are now trending neutral relative to annual comps of 6-20% in the five years prior to the incidents.

We think the challenges Yum China is currently facing are temporary and believe a resumption in sales growth will lead to a dramatic acceleration in profits. Such a scenario does not require heroic assumptions. Unit sales volumes are 25% below Yum China's prior peak of $1.6 million per restaurant, achieved just five years ago. But even if we assume 0% traffic growth, Same Stores Sales (SSS) should grow 3% a year based upon historical pricing patterns. Even minimal SSS growth is impactful due to the inherent operating leverage within the model (Yum China owns 80% of its restaurants). Just 1% growth in SSS translates into an extra five cents per share in earnings per share (EPS).

Our belief in a resumption in sales growth is based on the idea that Yum China's three-decade presence in the country has created deeply rooted brand equity. A 2016 brand image survey, conducted by AC Nielson, highlighted Yum China's strong brand resonance in the country with 60% of survey respondents naming KFC as their most preferred QSR brand. A recent survey by Euromonitor also illustrated Yum China's strong brand position with survey respondents naming KFC as the best western QSR and Pizza Hut as the best pizza operator.

We think one of the most underappreciated aspects of Yum China's growth prospects is enhanced utilization of the digital channel. The company counts Alibaba as a strategic partner after the firm invested half a billion dollars together with Primavera Capital Group, a private equity firm run by the former head of Goldman Sachs China, Fred Hu. Mr. Hu is also Chairman of Yum China's board.

The strategic partnership has paid off with Yum China generating over $1B in cashless payments in the last year. Yum China has utilized insights gleaned from payment data to cross-pollinate digital marketing channels and now counts over 100 million social media fans. That in turn has helped fuel growth in Yum China's digital loyalty program, one of the largest company loyalty programs in the world at 93 million members.

One of the most compelling aspects of our Yum China investment is the company's attractive reinvestment dynamics. Even with 7,600 restaurants, Yum China's growth opportunities within the Middle Kingdom remain substantial. Restaurant penetration is still nascent with 20 units per million people versus the US at 600 units per million people. Relative to Yum China in other Asian markets, the company is underpenetrated in China. For example, the company has 25 restaurants per million people in Hong Kong and 33 per million people in Malaysia. This compares to only 5 Yum China restaurants per million people in China.

Tertiary cities present a compelling opportunity for expansion with rising consumption, limited chain restaurant competition and greater demand for value offerings. Because of its nationwide distribution system, Yum China is better positioned than any other chain restaurant operator in China to cater to this demographic.

Management believes Yum China can triple its number of units over ensuing years. Importantly, Yum China believes it can self-fund growth due to its $600 million in annual free cash flow. New unit economics are compelling with recent new-builds generating cash on cash returns of 26-40% within the first year, suggesting payback in only 3-4 years.

Apart from existing owned brands, M&A offers opportunities for growth. Yum China is particularly well-positioned in this regard with $1 billion in net cash on its balance sheet and the best restaurant supply chain in China.

Despite its share- leading market position, cash generative economics, and abundant growth opportunities, Yum China is priced like a sub-scale local fast food purveyor with a commoditized offering. Yum China trades at a 10.5x 2018 EV/EBITDA multiple, at parity with competitively disadvantaged, local QSRs. We think a more relevant comp is global master franchises which share a similar growth profile and trade for an average EV/EBITDA multiple of 14.5X.

With Yum China, you have trough earnings and a trough multiple. You get the double-barreled effect of improving business economics and a rising multiple. In addition, you get intriguing optionality on utilizing technology to enhance returns, rolling out new concepts, such as Taco Bell, or tapping Yum China's net cash balance sheet for value accretive M&A. In time, the merits of Yum China's business will be recognized by the market. We think steady execution without any heroic assumptions can offer a double in price over the next four years.

It would seem the CEO of Yum China, Micky Pant, agrees – having purchased over $3 million worth of shares in April.