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In China, Yum and McDonald's likely need more than an ownership change

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KFC outlets in China serve Chinese-style menu items. (Photo by Mariko Tai)

HONG KONG -- China's fast-food sector has been dominated by U.S. chains like Yum's KFC and Pizza Hut as well as McDonald's. But now a question hangs over these household brands: Can new owners reverse their declining fortunes?

China Investment Corporation, a sovereign wealth fund, is reportedly leading a consortium that also includes Baring Private Equity Asia and KKR & Co. to acquire as much as 100% of Yum's China division, valued at up to $8 billion. According to a Bloomberg report, Singaporean sovereign wealth fund Temasek Holdings, teaming with Primavera Capital, is also vying for a stake in Yum China, whose spinoff plans were announced on Oct. 20 -- five days after Keith Meister, an activist hedge fund manager and protege of corporate raider Carl Icahn, joined the board.

Meanwhile, McDonald's is likely to start auctioning its North Asian businesses in three to four weeks. Among its would-be suitors are state-owned China Resources, Bain Capital of the U.S. and South Korea's MBK Partners, among other buyout firms. The winner or winners would oversee more than 2,800 franchises -- plus another 1,500 to be added during the next five years -- in China, Hong Kong and South Korea.

The company on Friday reported that sales in China surged 7.2% in the first quarter ended in March.

Yum's and McDonald's goal to become pure-play franchisers comes as competition in China's food services market is heating up and as middle-class consumers grow increasingly concerned about food safety and nutrition.

Hard hit by a series of food scandals since 2012, Yum China, once the darling of the international Yum group, saw its market share shrink to 24% in 2015 from 40% five years earlier. Sales also declined, dragging down the entire group's revenue.

Franchising -- which could help accelerate growth, free up capital and generate stable earnings -- could be a lifesaver to both western fast-food giants. But industry observers are skeptical that new owners can help Yum or McDonald's regain their former glory in China, where numerous food scares have made operational control crucial. Another problem is that Chinese fast-food providers are gaining ground on the American icons.

For Western players, China is becoming much more challenging.

Low-growth reality

"At least 51% of the China restaurant business is management, with the rest being franchise, brand, consumer taste for food and capital," said Jeffrey Towson, a professor of investment at Peking University's Guanghua School of Management. Towson attributed Yum China's past success to Sam Su, a Taiwanese who took four outlets and in 27 years built Yum China into an empire with thousands of eateries. Some of Su's success came from constantly updating and localizing menus.

But Su retired from his role as chairman of Yum China in August. Yum's vague long-term succession plan is now dimming its prospects in China, Towson said. "I'd be surprised," the professor said, "if the bidders for Yum aren't also trying to get [Su] on their team somehow."

Su still serves on the board of directors and also as an executive adviser to the new head of Yum China, Micky Pant, but none of the senior officers seem to have management experience in China or East Asia.

"It's not obvious [that] new owners will have greater skill or vision at reigniting now-gone high growth," said Peter Fuhrman, chairman of China First Capital, a boutique investment bank specializing in greater China. "In fact, if industry veterans, with a deep accumulated knowledge of finding, opening and operating restaurants in China, haven't been able thus far to solve this problem and arrest the slide, it's hard to see how a financial investor can."

Fuhrman, however, believes would-be suitors could still profit from a deal. "They will hope to arbitrage the difference in how American and Chinese investors value the business," he said. "One does this by buying a business or subsidiary quoted in the U.S. and find a way to either [list] it or sell on to new owners in China."

Joel Silverstein, president of East West Hospitality Group, a restaurant and hotel investment advisory, is also cautious. He said private equity firms, which tend to hold their investments for no more than five years, would be "passive investors" and have difficulty bringing added value or expertise to improve performance of these chains. "Their main interest is, of course, having a public vehicle in place to allow them eventually to exit," said Silverstein, referring to Yum China, which he believes would most likely be listed in Hong Kong.

Silverstein said private equity firms still see tremendous opportunity in Yum China because the group has yet to penetrate into many smaller cities, those with populations of no more than 250,000. As these cities expand, their fast-food markets could promise sizable growth.

As of the end of first quarter, Yum China had 7,207 restaurants, 5,019 of which were KFCs.

"Both McDonald's and Yum are extremely well-run global businesses, proven to have a lot of consumer appeal," Silverstein said. They "will be fine over the next five to 10 years, in spite of slower growth.

The hospitality consultant noted that Yum China's logistics and supply chain are national in scale, which give the company a big competitive advantage. "And there's no reason Yum China couldn't buy another chain and continue to grow," Silverstein said, referring to the group's acquisition of Little Sheep, a chain of Chinese hotpot joints for $587 million in 2011.

Silverstein believes the primary factor behind the expected spinoff is shareholder activism, which is commonplace in the U.S. For instance, Starboard Value, a New York-based hedge fund, in 2014 ousted the entire board of Darden restaurants after becoming its largest shareholder with an 8.8% stake. That same year, TGI Fridays, a Texas-based casual dining chain, switched to franchising after being acquired by private-equity firms Sentinel Capital Partners and TriArtisan Capital Partners.

The new Pizza Hut branch that opened in central Beijing this year was designed to reflect traditional Chinese architecture. (Photo by Mariko Tai)

Yum in December said that taking Yum China public would improve investor returns by 15% every year, while unlocking up to $6.2 billion in capital for shareholders before the separation is completed. The company also said it could continue to benefit from China's growth by keeping 3% of sales made at KFCs, Pizza Huts and Taco Bells in China through a licensing deal.

Plans to divest the China business have not changed even though Yum reported better-than-expected first-quarter results on Wednesday, largely supported by 42% growth in operating profit in its China division on the back of a 6% improvement in same-store sales compared to a year ago. The China business has been slowing since 2012 but still accounts for 50% of total group revenue.

"We remain on track to complete the spinoff by year-end," said David Russell, Yum's interim chief financial officer, during an earnings conference call. He said the company will file documentation about the divestment to the U.S. Securities and Exchange Commission in early May and conduct a roadshow.

"Yum China hit the peak of the [product] cycle years ago," said Junheng Li, founder and president of JL Warren Capital, a China-focus equity research firm in New York. "The Chinese market is saturated with KFC stores, and the brand equity is decaying.

"None of this suggests that Yum China as a stand-alone company does not have value. It merely suggests that the valuation should reflect a no- or low-growth mode."

She added that Yum China's business is currently overvalued. "They have really done all they could to keep the brand fresh and relevant in today's highly competitive market," Li said. "There is little the company can do to rejuvenate [Yum China]."